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# Essays on financial supervisory liability

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# Essays
# on
# Financial Supervisory Liability

Robert J. Dijkstra

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PROEFSCHRIFT

ter verkrijging van de graad van doctor
aan Tilburg University,
op gezag van de rector magnificus,
prof. dr. E.H.L. Aarts,
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door

Robert Johnny Dijkstra

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*For my parents*

# Preface

I began my PhD research at the start of what would become the worst financial crisis since the Great Depression of the 1930s. In this period, financial supervisory authorities all over the world were criticized for their roles in the crisis. No wonder the topic of financial supervisory liability became more visible than ever in media and legal literature. One could not have wished for a more opportune time to be writing a dissertation on this topic.

This is not the first study to deal with financial supervisory liability. However, it addresses several important gaps in our knowledge about this topic. Therefore, I hope that this study will contribute to a better understanding of financial supervisory liability and in this way contribute to the current debate.

This dissertation could not have been completed without the guidance of my three supervisors, Maurits, Louis, and Machteld, for which I thank them. In the past seven years, I have met a number of interesting persons whose feedback encouraged me to complete this dissertation: René Smits, Ross S. Delston, Dalvinder Singh, Andrew Campbell, Michael Faure, Donal Nolan, Alicia Novoa, and Vincent Buskens. All supported me in different phases of my PhD journey, for which I'm grateful.

Furthermore, I would like to thank the members of the PhD committee for the acceptance of their task in reviewing my dissertation.

Diemen, May 2015

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# 1 Introduction

## *1.1 Background*

Who does not remember the huge queue of people standing in front of the doors of the British mortgage bank Northern Rock in 2007—an image not seen since the crisis of 1929—afraid of losing all their money? Or what about the bankruptcy of the bank Landsbanki, better known as Icesave, in 2008, resulting in one of the worst economic and political crises in Iceland? Both events were part of the financial crisis that hit our world in 2007 and 2008, considered by many the worst financial crisis since the Great Depression of the 1930s. Although the responsibility for the crisis can not be easily determined, it is now widely recognized that authorities charged with the supervision of banks and other financial institutions played their parts in this crisis (Nolan, 2013).

The De Larosière report (Larosière et al., 2009) mentions, for instance, on page 39: "*Although the way in which the financial sector has been supervised in the EU has not been one of the primary causes behind the crisis, there have been real and important supervisory failures, from both a macro and micro-prudential standpoint.*" The conclusion of the Treasury Committee of the House of Commons (2008) in relation to the role of the British Financial Services Authority (FSA) regarding the collapse of Northern Rock is also quite clear. Page 34 of this report reveals: *"In the case of Northern Rock, the FSA appears to have systematically failed in its duty as a regulator to ensure Northern Rock would not pose such a systemic risk, and this failure contributed significantly to the difficulties, and risks to the public purse, that have followed."* More recently, the Commission Evaluation Nationalisation SNS Reaal concluded that the Dutch Central Bank (DNB) failed in the supervision of SNS Reaal in the period prior to the latter's nationalization in 2013 (Hoekstra & Frijns, 2014).

Financial supervisory failure will ultimately raise questions about liability. Is it possible to hold financial supervisory authorities liable for shortcomings in their performance of financial supervision?[1] In most European countries, this is indeed the case (Dijkstra, 2012). Financial supervisory authorities can be held liable not only by third parties, such as depositors, but also by financial institutions subject to their supervision (Tison, 2003). By intervening too quickly or too strictly, a financial supervisory authority can, for instance, create damage, as such intervention might affect the reputation of the financial institution. The financial institution can then try to hold the financial supervisory authority liable for the damage caused by this unjustified intervention. If, however, the authority acts in too lenient a manner, the financial institution can get into serious trouble that can result eventually in its

[1] For example: Immediately after the publication (23 January 2014) of the report from the Commission Evaluation Nationalisation SNS Reaal, the director of the Association of Shareholders (in Dutch: VEB) mentioned in the media that he will examine possibilities for holding DNB liable for the losses of the shareholders of SNS Reaal. (http://www.telegraaf.nl/dft/nieuws_dft/22236138/_VEB_laat_juristen_kijken_naar_claim_tegen_DNB_.html).

bankruptcy. This is likely to cause damage to third parties (investors, depositors, and other creditors), for which they will try to be compensated by suing the financial supervisory authority. It may be alleged, for example, that the authority, faced with indications of problems at the financial institution, should have acted more decisively to protect depositors (e.g. Tison, 2003; Athanassiou, 2011; Nolan, 2013). Financial supervisory liability is not merely a theoretical possibility. A number of financial supervisory authorities in the EU have been sued in recent years by both third parties and financial institutions under supervision.[2]

### *1.2 Arguments against or in favour of limited financial supervisory liability*

The fact that financial supervisory authorities can be held liable by both third parties and the institutions they supervise illustrates the difficult context in which they operate. Financial supervisory authorities need to balance conflicting interests, especially in the case of financial institutions in distress. On the one hand, they are responsible for maintaining the soundness of financial institutions and the financial system as a whole; on the other hand, they are charged with protecting depositors and other creditors of financial institutions (Tison, 2003). This is often referred to as the financial supervisor's dilemma. It is, therefore, not surprising that the topic of financial supervisory liability has been discussed frequently in recent years (e.g. Giesen, 2006; Van Dam, 2006a; Dempegiotis, 2008; De Kezel et al*.,* 2009; Dragomir, 2010; Busch, 2011; Athanassiou, 2011; Nolan, 2013). At the centre of the discussion is the question whether financial supervisory liability should be limited or not (Athanassiou, 2011).

In this discussion, politicians, legislators, and legal scholars use various arguments against or in favour of (limited) financial supervisory liability. The starting point of this discussion can be retrieved from Diceys conception of the rule of law (Dicey, 1915). Under normal circumstances, one would expect that public authorities, and thus also financial supervisory authorities, should be treated in the same way as other defendants. The fact that a public body is vested with wide responsibilities and limited

[2] Well-known cases include "Kechichian" in which the State of France (on behalf of the financial supervision authority) was held liable based on the proclaimed deficient financial supervision of the United Banking Corporation (Conseil d'État 30 November 2001, AJDA 2002.136) and the "Three Rivers" case, in which the Bank of England was held liable by depositors based on the proclaimed failure of the Bank to carry out its responsibilities under the Banking Act 1987 in light of the bankruptcy of the Bank of Credit and Commerce International (2001, 2 All ER 513). The Italian Supreme Court decided in a judgment that the Consob, the public authority responsible for regularing the Italian securities market, could be held liable towards investors for its negligence in vetting a prospectus (Corte di Cassazione, 3 March 2001, case no. 3132). In the Netherlands, the Insurance Supervisory Authority (now part of the Dutch Central Bank) was sued by third parties based on the proclaimed supervisory failure of the authority in light of the bankruptcy of the life insurance company Vie d'Or (HR 13 October 2006, LJN: AW2077, C04/279HR). The Spanish Securities and Exchange Commission (CNMV) was held liable by investors based on proclaimed supervisory failure in light of the bankruptcy of the financial intermediary Gescartera (Tribunal Supremo, No. 5921/2004).

resources does not mean that a special immunity should be granted in certain circumstances.

This line of reasoning is often supported by the idea that there is a need to hold supervisors accountable for their acts or omissions and to give them incentives to act in the public interest (Athanassiou, 2011). In this perspective, financial supervisory liability stimulates financial supervisors to take adequate care in the performance of their supervisory duties (Giesen, 2006; Van Dam, 2006a; De Kezel et al., 2009; Busch, 2011). This argument is based on the general law and economics notion that tort law prevents negligent conduct from happening (e.g. Cooter & Ulen, 2008).

Another argument in favour of applying normal liability rules is compensation. Compensation would, of course, be best served without introducing any limitations on financial supervisory liability. The argument of compensation does not, however, play an important role in the debate. It merely serves as a supportive argument (Giesen, 2006). A plausible reason for this, amongst others, is the existence of a deposit guarantee system as an alternative compensation mechanism. This system provides, to a certain limit, compensation for the losses of depositors when a financial institution goes bankrupt.

A less frequently used argument is fairness. From a fairness perspective, it is difficult to accept that parties can be denied their right to recover compensation for their losses from those who have caused them through their wrongful acts, or negligent omissions (Athanassiou, 2011). Fairness can, however, also be used as an argument in favour of limited financial supervisory liability. One could question whether it is fair to expose a party to liability grossly disproportionate to his fault; it is the wrongful behaviour of the financial institution that caused the damage in the first place. As both views on fairness can be considered compelling, it is not so strange that this argument is less decisive in the discussion.

When limiting the liability of their financial supervisory authorities, politicians and legislators often refer to the legal situations in neighboring countries. Belgian legislators, for instance, referred explicitly to Germany when limiting the liability of their financial supervisory authorities to cases of gross negligence and/or bad faith in 2002 (De Kezel et al., 2009). The introduction of a standard of bad faith for the supervisory authorities in Ireland was inspired by the situation in the United Kingdom (Doherty & Lenihan, 2005), and Dutch politicians referred to the limited-liability regimes of neighboring countries when introducing a standard of gross negligence and/or bad faith in 2012.[3] Politicians are thus using the limited financial supervisory

[3] See Dutch Parliament 2011/2012, explanatory memorandum regarding the law on limited liability for DNB and AFM, publication 33 058, no. 3, pp. 1-6.

liability regimes in other countries as a reason for limiting the liability of their own financial supervisory authorities.

Another reason in favour of limited financial supervisory liability is the fear of a huge number of damage claims (the "floodgates argument"). This reason assumes that applying normal liability rules to financial supervisory authorities would result in a dramatic increase in litigation (Giesen, 2006; Athanassiou, 2011). This is most likely to happen in the case of bankruptcy of a financial institution. To be fully compensated, victims will, in this situation, turn to the 'deep pockets' of financial supervisory authorities, as bankrupted financial institutions probably do not offer sufficient means for compensation. This would then impose a huge financial burden on the State and indirectly operate as an undesirable transfer of wealth (Athanassiou, 2011).

Closely related to the floodgates argument is the, frequently used, argument of defensive conduct, or in our case, defensive financial supervision (Giesen, 2006). It is argued that the huge number of damage claims would have a chilling effect on performing effective financial supervision (Delston & Campbell, 2007).[4] The fear of being held liable is, in this situation, so severe that one starts to act with too much caution when dealing with the supervisee. This line of reasoning is not new. Defensive conduct is one of the traditional arguments against public authority liability used especially in commonwealth countries (e.g. Booth & Squires, 2005; Dari-Mattiacci, 2010). It is, therefore not surprising that this argument is also being used in the context of financial supervisory authorities.

Based on the reasons mentioned above, legislators, politicians and scholars prefer either to limit financial supervisory liability or apply normal liability rules (in most cases negligence) to financial supervisory authorities.

### *1.3 This study*

This study revolves around three specific arguments mentioned in the section above, namely referring to limited financial supervisory liability regimes, defensive conduct and careful financial supervision. These arguments often play a major role in the discussion whether or not to limit the liability of financial supervisory authorities. In this perspective, the case of the Netherlands is illustrative. The Dutch government explicitly referred to limited liability regimes in neighboring countries and the fear for defensive conduct when they limited the liability of their own financial supervisory authorities to cases of gross negligence and/or bad faith in 2002.[5]

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[4] See also fn 3.
[5] See fn 3.

However, when examining these three arguments, it is important to consider the theoretical and/or empirical evidence, or lack thereof, that often underpins them. So, to what extent do these arguments actually hold true? This question is at the centre of my study. Answering this question will provide politicians, legislators and scholars a better theoretical and empirical foundation regarding the arguments that do hold true. This may support them in their decision making processes regarding whether financial supervisory liability should be limited or not.

In order to answer the research question, I will examine five gaps in our knowledge that relate to these three arguments. The first gap relates to our knowledge about financial supervisory liability regimes in other countries. More specifically, it relates to the fact that politicians often refer to the limited liability regimes in neighboring countries as an argument for limiting the liability of their own financial supervisory authorities. Are these references valid and to what extent is referring to limited financial supervisory liability regimes a convincing argument?

The more dominant limited financial supervisory liability is, the stronger this argument becomes. In recent years, a number of legal scholars have performed comparative research. Andenas and Fairgrieve (2000) compared, for instance, state liability for negligent banking supervision in England, France, and Germany. Tison (2005) described the financial supervisory liability regimes in Germany, France, Belgium, the United Kingdom, Ireland, and Luxembourg. In his report "Liability of Regulators", Van Dam (2006a) included country analyses of Germany, Belgium, England and Wales, Italy, and France that also described the liability regime for financial supervisory authorities. Finally, De Kezel et al. (2009) compared financial supervisory liability regimes in the Netherlands, Belgium, France, Luxembourg, Switzerland, the United Kingdom, and the United States. All these comparative studies include a number of EU member states but certainly not all of them. Because of the ongoing process of 'Europeanization' of financial law and supervision, broader knowledge of financial supervisory liability can support both individual member states as well as the EU in developing future legislation.

So, what does the liability regime for financial supervisory authorities in the member states look like? And is there a dominant financial supervisory liability regime in the EU? These questions reflect the first gap in our knowledge about financial supervisory liability.

The second gap relates to our (theoretical) knowledge about the deterrent impact of financial supervisory liability. In the existing literature, the deterrent effect of financial supervisory liability is often described in general terms. Participants in the discussion frequently state that financial supervisory liability results in defensive conduct or prevents unlawful conduct from happening.[6] In doing so, they seem to refer to general, widely used insights from law and economics theories about the deterrent impact of tort law. However, the deterrent impact of liability rules can not be examined without taking into account the specific context in which the actors, in this case financial supervisory authorities, operate. Thus, what are the characteristics of this context, and how do they influence the deterrent impact of financial supervisory liability? These questions can be considered as the second gap in our knowledge about financial supervisory liability. Knowledge of and insight into these characteristics will contribute to a better understanding of the most likely behavioural impact of financial supervisory liability.

Financial supervisory liability is not the only instrument that, at least theoretically, can provide financial supervisory authorities with incentives to behave carefully. It is merely one of the many accountability arrangements that govern financial supervisory authorities. These arrangements need to ensure that authorities perform their supervisory roles with adequate care (e.g. Kane, 1989; Ward, 2002; Schüler, 2003; Tabellini, 2008). The impact of financial supervisory liability is, however, often discussed without taking into account the role of these other mechanisms. In order to evaluate the role of tort law with regard to its deterrent effect, it is also important to explore the roles of other accountability arrangements. Depending on the incentive-generating capacity of these other accountability arrangements, the deterrent impact of financial supervisory liability can be considered a more important or less important argument. However, we need to be aware that insofar as there are various incentive generating mechanisms that might serve as alternatives to liability, financial supervisory liability law might have the capacity to interact with those other incentives in a beneficial way. For instance, financial supervisory liability can generate publicity that stimulates financial supervisory authorities to behave carefully (Schwartz, 1094). So, what kinds of accountability arrangements exist? And to what extent are they able to provide financial supervisory authorities with incentives to behave carefully in comparison with tort law? Examining this knowledge gap will provide us with a clearer picture about the relative importance of the deterrence argument.

Financial supervisory liability is often triggered by the bankruptcy of a financial institution. People who have suffered damage from a bankruptcy are searching for means of compensation and will try to be compensated by holding financial

[6] Sometimes, views on the deterrent impact of financial supervisory change. This is nicely illustrated by the changing view of Dutch politicians on the impact of financial supervisory liability. While Wouter Bos, the Dutch Minister of Finance in the period 2007–2010, favoured applying normal liability rules (negligence) for financial supervisory authorities by referring to the preventive effect, his successor, Jan Kees de Jager (2010–2012) prepared the bill for limiting the liability of the Dutch financial supervisory authorities based on the possible chilling effect normal liability rules (negligence) have on performing effective financial supervision. This confirms the need for insights in the underlying assumptions behind the proclaimed deterrent impact.

supervisory authorities liable. In this situation, tort law is not the only mechanism people can rely on to receive compensation for their losses. Victims of bankrupted financial institutions will often receive compensation from a deposit guarantee system. This raises some interesting questions. First of all, one could ask to what extent this alternative compensation system affects the incentives of depositors, financial institutions, and financial supervisory authorities in comparison with tort law. In addition, one might ask how this alternative compensation mechanism influences tort law itself with regards to its incentive-generating capacity. These questions are seldom mentioned when discussing financial supervisory liability and can thus be considered to reflect the fourth gap in our knowledge about financial supervisory liability.

In the discussion about whether financial supervisory liability should be limited or not, both prevention and defensive conduct are used as arguments. Whether financial supervisory liability promotes more-effective financial supervision, encourages defensive conduct, or has no significant effect is, however, at heart an empirical question. Only empirical research is able to validate the actual impact of financial supervisory liability on the behaviour of financial supervisory authorities. To my knowledge, there is hardly any empirical research regarding the behavioural impact of financial supervisory liability. Only Van Dam (2006) and Trebus & Van Dijck (2014) have undertaken limited empirical research in this area. Based on a short questionnaire and interviews with Dutch financial authorities, Van Dam mentioned, according to the statements of the supervisors, there was no indication for defensive conduct. Trebus & Van Dijck carried out interviews with employees of the Dutch Financial Markets Authority in order to examine the impact of liability on their behaviour. Based on their research they conclude that liability has almost no impact on the behaviour of financial supervisors. This limited empirical research can, however, not be seen as overwhelming empirical evidence regarding the impact of financial supervisory liability. This lack of empirical research is the fifth gap in our knowledge that this study will aim to address.

### *1.4 Structure of this study*

To answer the central research question, I conducted five studies presented in Chapters 2-6. Each of these chapters has been published as a separate article. Chapter 5 has been co-authored by Michael Faure. All these chapters deal with one of the five knowledge gaps identified in the previous section. In addition, Chapter 7 presents the conclusion of this study.

*Chapter 2 Liability of financial supervisory authorities in the European Union*
Chapter 2 appeared in the *Journal of European Tort Law* (Dijkstra, 2012). It contains an overview of third party financial supervisory liability regimes in the EU member

states.[7] It elaborates on earlier comparative research by adding more countries and introducing weighting criteria to reflect the importance of each EU member state. Chapter 2 describes the liability regimes of 48 financial supervisory authorities in 28 member states. In order to do so, I examined legal literature regarding financial supervisory liability, national legislation governing financial supervisory authorities, and legislation that dealt with the liability of public authorities in general. To categorize the liability regimes, I defined five liability categories. In most of the cases, national legislation or legal literature clarified in which liability category a financial supervisory authority belonged. National experts (legal scholars and members of the financial supervisory authorities) were asked to review the outcome of my research. By using weighting criteria that reflect the importance of each member state in the EU, I was able to compare the use of different liability regimes in the EU. This chapter will, therefore, augment our knowledge about financial supervisory liability regimes in the EU.

*Chapter 3 Liability of financial supervisory authorities: Defensive conduct or careful supervision?*
Chapter 3 appeared in the *Journal of Banking Regulation* (Dijkstra, 2009). In this chapter, I evaluate the role of liability rules in preventing negligent financial supervision, and, in particular, I examine the incentive effects of liability rules on the behaviour of financial supervisory authorities. In other words, will the application of tort law lead to defensive conduct, or is it an adequate mechanism to promote careful financial supervision? I start by describing a basic economic model of third party financial supervisory liability. This model is derived from law and economics literature and shows how tort law, in theory, can encourage financial supervisory authorities to exercise careful supervision. Financial supervisory authorities, however, operate in a context of specific characteristics that are likely to influence the deterrence impact of tort law. Using literature regarding the Dutch financial supervisory authorities, I identify these specific characteristics that deviate from the conditions mentioned in the basic economic model. Next, I show for all these characteristics whether the proclaimed effect of tort law is positively or negatively influenced. Because it is very difficult, if not impossible, to measure the exact magnitude of these effects, I make a qualitative judgment as to the likely impact of tort law on, in this case, the behaviour of Dutch financial supervisory authorities. This chapter thus provides a clearer theoretical understanding of the deterrent impact of financial supervisory liability.

*Chapter 4 Accountability of financial supervisory authorities: An incentive approach*
Chapter 4 was published in the *Journal of Banking Regulation* (Dijkstra, 2010). A lack of adequate accountability arrangements is often mentioned as a cause for financial supervisory failure (e.g. Kane, 1989; Ward, 2002; Schüler, 2003; Tabellini, 2008). This

[7] At the time of my research, Croatia (the 28th member state) was not yet a member of the EU. Article 10 of the Act on Croatian Financial Services Supervisory Agency, however, limits the liability of the Croatian financial supervisory authority to cases of gross negligence and/or bad faith (Dijkstra, 2014).

chapter, therefore, examines to what extent existing accountability arrangements, including financial supervisory liability, can provide incentives for taking adequate care in the performance of financial supervision. By using insights from public-choice theory and principal-agent theory, I first identify possible conflicts between society and financial supervisory authorities that can lead to supervisory failure. Next, I examine which consequences may result from being held accountable for this failure and whether these consequences provide effective incentives that stimulate financial supervisory authorities to pursue the public interest. This chapter thus places financial supervisory liability in the broader perspective of accountability for supervisory failure and helps to determine the relative importance of the deterrence argument.

*Chapter 5 Compensating victims of bankrupted financial institutions: A law and economic analysis*
Chapter 5 was co-authored by Michael Faure and published in the *Journal of Financial Regulation and Compliance* (Dijkstra & Faure, 2010). In addition, the paper was presented at the Annual Meeting of the European Association of Law and Economics (Paris, 23 September 2010). Financial supervisory liability is not the only mechanism that can provide compensation for damages. Therefore, this chapter explores how different compensation mechanisms affect incentives for the welfare-improving behaviour of all stakeholders involved, namely, depositors, financial institutions, and financial supervisory authorities. We identify, by examining legislation and legal literature, the different compensation mechanisms depositors can rely on when they face losses as a result of the bankruptcy of a financial institution. Next, we perform an economic analysis of these mechanisms. With the use of insights from law and economics, we make predictions with regard to the incentive effects of compensation mechanisms on all parties involved. Furthermore, we show how these mechanisms influence each other with regard to their incentive-generating capacity. This chapter helps us to better understand the role of compensation mechanisms in relation to incentives for welfare-improving behaviour.

*Chapter 6 Is limiting financial supervisory liability a way to prevent defensive conduct? The outcome of a European Survey*
Chapter 6 presents the outcome of an empirical study on the impact of financial supervisory liability. This chapter was published in the *European Journal of Law and Economics* (Dijkstra, 2015). The central research question focuses on the likelihood that normal liability rules (no-fault and negligence) result in defensive conduct, and, if that is the case, to what extent limiting financial supervisory liability (gross negligence and bad faith) will prevent defensive conduct from happening. Because objective data on the impact of financial supervisory liability is difficult, if not impossible, to obtain, I adopt the strategy of exploring this impact through the perceptions of financial supervisors. In order to do so, I developed an online survey that was sent to senior financial supervisors working in 48 financial supervisory authorities in 27 member states of the EU. The main part of the survey presents a series of statements, asking

respondents to state their opinions about the impact of financial supervisory liability by means of a 5-point Likert-type scale. This chapter reports the findings from the survey and, therefore, helps to fill the empirical gap in our knowledge about the impact of financial supervisory liability.

*Chapter 7 Conclusion*
Chapter 7 summarizes the findings of this study. This chapter also presents the answer to the central research question. In addition, it sets forth some final thoughts concerning the answer to the question of whether or not financial supervisory liability should be limited that can be drawn from the findings of this study.

### *1.5 Limitations and terminology used in this study*

Before turning to the different chapters, it is useful to briefly consider main limitations, terminology, and more specifically, the meaning of certain terms used in this study. In this study, the term "financial supervisory liability" is used to express the liability of the institution itself. Individual liability of staff members of the financial supervisory authority, therefore, falls outside the scope of this study. The main reason for this choice is the fact it is almost always the employer, in our case the financial supervisory authority itself, who is being held liable for the actions or omissions of its employees (vicarious liability). In addition, the term "normal liability rules" refers to liability rules that are formally not limited such as (simple) negligence and rules of no-fault (e.g. strict liability).

Furthermore, the study focuses only on the third party liability of financial supervisory authorities, as this liability category receives the most attention in society. Administrative review procedures or liability claims brought by financial institutions subject to supervision are, therefore, not covered. It is however worthwhile to notice that tighter financial regulation in combination with more strict financial supervision, as a result of the financial crisis, is likely to result in more future liability claims from financial institutions subject to supervision.

As mentioned earlier, this study examines five gaps in our knowledge that relate to three dominant arguments in the debate about financial supervisory liability. By examining these gaps, it becomes clear to what extent these three arguments hold true. In doing so, this study contributes to a higher quality decision making process regarding whether financial supervisory liability should be limited or not. This study does however not cover all issues relevant for the underlying policy question of limiting financial supervisory liability. The normative issue whether (limited) financial supervisory liability is fair or reasonable is, for instance, not investigated in this study as such. Some authors point out that exposing a financial supervisory authority to liability grossly disproportionate to his negligence is inherently unfair (Giesen, 2005; Squires, 2006). On the other hand, refusing or limiting the victims' rights to recover damages can also be seen as unfair (Athanassiou, 2011). Fairness debates may also relate to what can be expected from depositors when they make decisions whom to entrust their money with. It is probably not fair to expect from depositors to closely monitor their financial institutions. However, a certain responsibility may be expected from this group. Whether fairness is used as an argument against or in favour of limited financial supervisory liability is often dependent on society's sense of what is fair. At times fairness, justice and reasonableness require greater protection for public authorities and at others there should be greater availability of damages for individuals who suffer harm (Squires, 2006).

Each chapter adds substantially to our knowledge about financial supervisory liability and, more specifically, about the three main arguments used in the debate. However, the method followed in this study has some limitations. When categorizing the member states, I use relative broad categories of liability and do not go into the intricacies of each of the 27 systems (Chapter 2). For a number of member states, legal scholars have already discussed the nuances of these regimes (Andenas & Fairgrieve, 2000; Tison, 2005; Van Dam, 2006a; De Kezel et al, 2009). This detailed knowledge can significantly contribute to understanding what type of intermediate regimes can be constructed, or, are preferred when countries obtain more experience in case law. However, to examine which member states in the EU have formally limited the liability of their financial supervisory authorities, we can use a less detailed approach. This approach is also a practical one: one would need substantial resources to carry out detailed research for 28 member states.

This study applies the standard law and economics model of profit maximizing behaviour in Chapter 3, 4 and 5 (Cooter & Ulen, 2007). The application of this model to public authorities is highly debated as these authorities do not pursue a goal of profit maximizing. Both Levinson (2000) and Schäfer (2012) argue, for instance, that public bodies are more responsive to political incentives than to liability claims and reject the application of traditional models of profit maximization to explain the behaviour of public authorities. On the other hand, Rosenthal (2006) argues that public authority liability reduces the resources available to politicians to pursue their favoured political agenda. Hence, there is an incentive to minimize exposure to tort claims. Niskanen (1971) suggests finally that the goal of budget maximization will replace profit maximization in a bureaucracy, since many of the objectives of a bureaucrat (power, prestige and salary) are directly tied to the size of the bureau that the bureaucrat oversees (Dijkstra, 2009). As public authority liability imposes some (political) costs (direct or indirect via negative publicity) upon public authorities which are likely to create some incentives to prevent misconduct, I have chosen to apply the profit maximizing model. This is, to my opinion, the most appropriate model to reflect that liability has an impact on the behaviour of financial supervisory authorities. The extent to which financial supervisory liability does have a deterrent effect, remains then to be investigated.

For more specific limitations and/or underlying assumptions of this study, I refer to the individual chapters. Every chapter contains information about specific limitations and/or assumptions regarding the conducted research. Furthermore, it is important to note that Chapters 2, 3, 4, and 5 were written between 2009 and 2012. During this period, the Dutch financial supervisory authorities were subject to a rule of negligence (based on article 6:162 of the Dutch Civil Code). However, as of 1 July 2012, the liability of the Dutch financial supervisory authorities has been limited to cases of gross negligence and/or bad faith.[8] In order to take this legislative change into account, I have included a commentary section at the ends of Chapters 2, 3, 4 and 5. These commentary sections discuss the extent to which this legislative change impacts the overall conclusions of these chapters. Chapter 7 takes the changed legal situation in the Netherlands fully into account.

This study is of interest to various stakeholders. It should be noted, however, that it is written primarily for policy makers, legislators, and (legal) scholars active in the field of financial supervisory liability.

[8] See article 1:25d of the Dutch Law on Financial Supervision (Stb. 2012/265).

# 2 Liability of financial supervisory authorities in the European Union

## *2.1 Introduction*

This chapter investigates the third party liability of financial supervisory authorities in the European Union (EU). Third party liability refers to a third party (e.g. depositors, shareholders, or bondholders) suffering damage from a financial institution and holding the financial supervisory authority liable on grounds of shortcomings in performing its supervisory role. This topic is becoming increasingly important from a European perspective due to the ongoing process of 'Europeanization' of financial law and supervision (Dragomir, 2010; Athanassiou, 2011). Member states are also increasingly looking to each other when discussing the topic of financial supervisory liability.[9] The goal of this chapter is to provide an overview of the European third party liability landscape with regards to financial supervisory authorities and to show the relative importance of the different third party liability regimes in the EU when taking into account certain weighting factors.

I carried out this research in three steps. First, the different liability categories were defined in order to categorise the financial supervisory liability regimes. By examining legal literature regarding (European) tort law, five general categories have been defined, namely no-fault liability, (simple) negligence, gross negligence, bad faith and immunity. These categories are described in detail in the beginning of Section 2.2. Next, the national financial supervisory liability regimes are described and categorised. The starting point was to identify the existing financial supervisory authorities in the different member states followed by a description of their liability.[10] In order to do this, legal literature regarding financial supervisory liability was examined along with national legislation governing financial supervisory authorities and legislation that dealt with the liability of public authorities in general.[11] In most of the cases, national legislation or legal literature clarified in which category a financial supervisory authority belonged. Other cases have been categorised to the author's best knowledge. In order to check the description and classification, national experts (legal scholars and members of the financial supervisory authorities) were asked to review the

[9] For instance, the Dutch Ministry of Finance recently prepared a draft bill in which the liability of the Dutch financial supervisory authorities will be limited to cases of bad faith and gross negligence. One of the arguments used by the Ministry is the Netherlands' differing liability regime compared to other countries, specifically Germany, France, Belgium and the United Kingdom, which have limited the liability of their financial supervisory authorities. See the memorandum of the Dutch Ministry of Finance FM 2011/6407M, dated 11 March 2011, regarding limiting the liability of financial supervisory authorities.

[10] The description is limited to a general description of the liability regimes; it does not, for instance, include the study of relevant case law or a detailed explanation of all requirements needed to hold a supervisory authority liable.

[11] These laws can be found using Lexadin (http://www.lexadin.nl/wlg/legis/nofr/legis.php).

outcome of the research.[12] Any inability to identify the applicable liability regime in a member state, or lack of response from a national expert, is clearly stated in the text. The third and last step of this research consists of a comparative analysis of the third party liability regimes by calculating the relative importance of each predefined liability category in the EU. This is done by adding up the number of financial supervisory authorities that belong to one of the predefined liability categories followed by a calculation of the relative share of one category in the total. In doing so three of the most common weighting factors that reflect the relative importance of individual member states were used, namely one vote per member state, population size and gross domestic product (GDP).

This chapter is structured as follows. Section 2.2 starts with a definition of the liability categories followed by a general description of the third party liability regimes in the member states of the EU. In this description, the liability regime is also categorised into one or more of the five pre-defined categories. Section 2.3 begins with an analysis of the research data of the previous section followed by the calculation of the relative importance of each pre-defined liability category in the EU. This section ends with some critical reflections on the research. In section 2.4 the conclusions to be drawn are outlined.

## *2.2 Financial supervisory liability in the EU – An overview*

### 2.2.1 Defining liability categories

What categories can we define in order to classify the financial supervisory liability regimes of the different member states? The first distinction that can be made is between liability and immunity, where immunity refers to a situation in which it is not possible to hold the financial supervisory authorities liable. But what about a further distinction of liability categories? Legal literature makes a general distinction between no-fault liability and fault based liability (e.g. Zweigert & Kötz, 1998; European Group on Tort Law, 2005; Van Dam, 2006b; Schäfer & Müller-Lander, 2009).

In this chapter no-fault liability refers to liability for unlawful or illegal conduct or breach of administrative regulations that does not require negligence or intentional wrongdoing. In other words, a plaintiff does not have to prove intent, recklessness or negligence on the defendant's part (Van Dam, 2006b). Because liability requires violation of the required (objective) standard of conduct, no-fault liability is not strict liability in the classic sense as found, for example, in liability in respect of hazardous activities or the control of dangerous things.

[12] The various experts are referred to per member state. Their many helpful comments contributed to the quality and reliability of this research. Any mistakes are, however, mine.

Fault liability is based on both negligent and intentional conduct (Van Dam, 2006b). Under a rule of (simple) negligence, the tortfeasor will only be held liable for failing to exercise ordinary care. This standard is also called reasonable care or due care, and is usually determined by the law and/or by the court (European Group on Tort Law, 2005). Where there is serious carelessness on the side of the tortfeasor, we speak of gross negligence. An actor classified as grossly negligent refers to someone whose actions have fallen so far below the ordinary standard of expected care that the label 'gross' is warranted. It relates to conduct or a failure to act that is so reckless that it demonstrates a substantial lack of concern for whether damage will result. One stage further produces the concept of bad faith. Bad faith or 'quasi-immunity' refers to intentional wrongdoing by an actor. Someone acts in bad faith when he knowingly acts outside the scope of his powers and with the knowledge that this action will likely cause damage to third parties. In this chapter I therefore make a distinction between no-fault liability, negligence, gross negligence, bad faith and immunity as shown in Figure 1.[13] The chapter assumes that the conduct giving rise to liability may be that of an employee or agent for which the authority is vicariously liable.

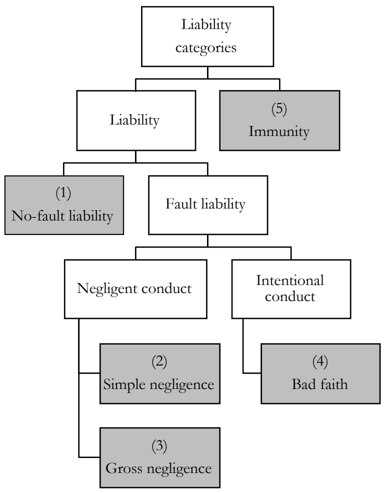


**Figure 1: Liability categories.**

[13] The classification of fault liability into negligence, gross negligence and bad faith regarding financial supervisory liability is in line with Tison (2003).

### 2.2.2 Overview

This section first describes per member state which authorities are engaged in financial supervision, secondly how their third party liability is arranged and thirdly to which liability category they can be allocated.[14]

**Austria**

Austria has had a single integrated supervisory authority since 2002, when the *Finanzmarktaufsichtsbehörde* or Financial Market Authority (FMA) was established under public law as an independent institution with its own legal personality (European Central Bank, 2010).[15] Its liability is stated in the Federal Act on the Institution and Organization of the Financial Market Authority (FMABG 97/2001). Section 3 para (1) of this Act states:

*The Federal Government shall be liable pursuant to the provisions of the Amtshaftungsgesetz (Public Liability Act, AHG), Federal Law Gazette No. 20/1949, for damage caused by the FMA's bodies and employees in the enforcement of the Federal Acts specified under section 2. Damage as defined in the present provision, is such that was directly caused to the legal entity subject to supervision pursuant to this federal act. The FMA as well as its employees and bodies shall not be liable towards the injured party.*

The provision that states that only damage suffered by the legal entities to be supervised by the FMA will be considered as 'damage' was added by the Austrian legislator during the global financial crisis in 2008 (Steininger, 2009). As a result, third party liability of the Austrian Federation as well as of the FMA is excluded (immunity).

**Belgium**

Since April 2011 financial supervision is carried out by the National Bank of Belgium (NBB) and the Financial Services and Markets Authority (FSMA).[16] Since reform of the supervision structure by the Law on the Supervision of the Financial Sector and on Financial Services 2002, Belgium limits the liability of its financial supervisors to gross rather than ordinary negligence (Van Dam, 2006a). Article 68 of this Act, together with article 26 (1) section 4 of the Law of 2nd of July 2010, states:

*The FSMA and NBB shall carry out their tasks exclusively in the public interest. The FSMA and NBB, the members of their bodies and the members of their staff shall not bear civil liability for their decisions, acts and conduct in the exercise of the legal tasks of the FSMA and NBB, save in the event of fraud or gross negligence.*

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[14] The information in this section is correct as of June 2012.
[15] See http://www.fma.gv.at/cms/site/EN/index.html.
[16] See http://www.cbfa.be/eng/index.asp.

**Bulgaria**[17]

Supervision of the financial sector in this country is performed by two authorities, namely the Bulgarian National Bank (BNB) and the Financial Supervision Commission (FSC).[18] As both of these authorities fall under the description of governmental bodies performing administrative functions, their liability for shortcomings in their supervisory role is governed by the provisions of the Law on the Liability of the State and the Municipalities for Damages.[19] Article 1 of this law states that 'the state and the municipalities shall be liable for damages inflicted on citizens and legal persons from unlawful acts, deeds or omissions of their bodies or officials upon, or on the occasion of, implementation of their administrative behaviour'. This means that, in theory, the BNB and FSC, in their capacity as governmental bodies, are liable for shortcomings in their supervisory roles if damage occurs. The liability provided for under the statute can be categorised as no-fault liability: in other words, liability could be established independently of whether the state (through its official) has acted intentionally or not. However, unlike the liability of the FSC, the liability of the BNB has been limited to actions in bad faith by the Law on Credit Institutions 2006. Article 79(8) of this law states that the Bulgarian National Bank, its bodies and the persons authorised by them shall not be liable for any damages caused in exercising their supervisory functions, unless they have acted with intent.

**Cyprus**

In Cyprus financial supervision is carried out by four institutions, namely the Central Bank of Cyprus, the Securities and Exchange Commission (SEC), the Insurance Company Control Service (ICCS) and the Cooperative Societies Supervision and Development Authority (CSSD) (European Central Bank, 2010). According to the Cyprus Banking Law (No. 66(1) 1997), the Central Bank of Cyprus is liable in cases of gross negligence or bad faith. This is based on Part XII, article 32(1) which states:

*The Central Bank and any person who is a Director or an officer of the Central Bank, shall be liable in any action suit or other legal proceedings for damages for anything done or omitted in the discharge of the functions and responsibilities of the Central Bank under this Law or under the Regulations issued under this Law, unless it is shown that the act or omission was not in good faith or the result of gross negligence.*

Insufficient information was available regarding the applicable third party liability rule for the SEC, the ICCS and the CSSD.

[17] I would like to thank Viktor Tokushev for his helpful comments on the topic of financial supervisory liability in Bulgaria.
[18] See http://www.bnb.bg/BankSupervision/index.htm and http://www.fsc.bg/?l=english.
[19] Promulgated in the State Gazette (SG) 60 from 5 August 1988, amended with SG 17 from 6 March 2009.

**Czech Republic**[20]

Supervision of the financial market in the Czech Republic is performed by an integrated supervisory authority, namely the Czech National Bank (CNB).[21] The banking legislation does not provide any explicit provision regarding the liability of the CNB. Therefore its liability is based on the State Liability Act.[22] According to articles 3 and 13 of this Act, the State (including all public authorities) is primarily liable for any damage caused by unlawful decisions or improper administrative actions by a legal entity or person in the course of executing public authority on the State's behalf. Supervision by the CNB clearly constitutes an exercise of public authority. The State is therefore liable for any damage caused to third parties as a result of any unlawful decision or improper administrative action of the CNB carried out in the exercise of its public authority. In theory, the liability standard is relatively low since it is based on no-fault liability. However, in practice, the substantive laws play an important role as there is no clear definition of what constitutes improper conduct (or supervisory failure). As a result, and despite several cases against the State for the unlawful conduct of the CNB, courts have yet to find the CNB guilty of not complying with its statutory obligations.

**Denmark**[23]

In Denmark, supervision over the financial sector is performed by a single supervisor, namely the Danish Financial Supervisory Authority (DFSA). The DFSA is part of the Ministry of Economic and Business Affairs. There are no specific provisions regarding the liability of the DFSA in Danish law. Its liability is therefore based on general liability rules as stated by the Danish courts as the Danish statute book contains no general provision on the liability in damages of public authorities. The Danish rules on public liability in damages for tortious acts and omissions originate from the general principles of civil law on liability in damages.[24] Liability is thus based on 'culpability' (negligence). It is impossible to give a comprehensive definition of 'culpability'. The acts or omissions of public authorities must be judged in the context of each particular case. In some cases, a slight error is sufficient to establish liability, while in others serious error must be proved. Public authorities can be made liable both for the failure of the administrative machinery and for the acts of their servants or agents acting within the scope of their duties. To date, no cases of financial supervisory liability have been brought before the Danish courts. Consequently, Danish courts have not

[20] I would like to thank the Czech Central Bank, Jiří Hrádek and Zdeněk Kudrna for their help in describing the situation in the Czech Republic.

[21] According to article 44 of the Act No. 6/1993 Coll. on the Czech National Bank.

[22] See Act No. 82/1998 Coll. on liability for damage incurred in the course of the exercise of public powers through a decision or incorrect procedure.

[23] I would like to thank Vibe Ulfbeck, Niels Vase and Troels Bay Simonson for their helpful comments regarding the Danish situation.

[24] In a 1943 judgment, the Danish Supreme Court stated that central government is liable for damage caused in the exercise of statutory powers. Regarding the liability of public authorities in Denmark, see also the report of Paul Hoyrup, Judge of the Supreme Court, at http://www.juradmin.eu/en/colloquiums/colloq_en_07.html.

yet been in the position to formulate specific principles of liability regarding the DFSA.

**Estonia**[25]

In Estonia supervision of the financial markets and financial institutions is performed by the Estonian Financial Supervision Authority (EFSA). The liability of the EFSA is addressed in § 58 of the Financial Supervision Act 2001 (RT I 2001, 48, 267) which states that '[t]he liability of the Supervision Authority for rights violated or damage caused in the conduct of financial supervision, and the bases of and procedure for the restoration of violated rights and the payment of compensation for damage caused shall be provided by law.' This article refers to the State Liability Act 2002 (RT I 2001, 47, 260). Paragraph 13(3) of the State Liability Act states that 'a public authority shall be relieved of liability for damage caused in the course of performance of public duties if the damage could not have been prevented even if diligence necessary for the performance of public duties had been fully observed'. Based on this paragraph and the comments from the experts, it follows that the EFSA will only be liable towards third parties in cases of actions or omissions made in bad faith. However, to date, the EFSA has not yet been subject to claims by third parties. Thus, there is no court practice to validate this assumption.

**Finland**

Since 1 January 2009, the *Finanssivalvonta* or Finnish Financial Supervisory Authority (FIN-FSA), is responsible for the supervision of Finland's financial sector. Administratively the FIN-FSA operates in cooperation with the Bank of Finland.[26] Section 69 of the Act on the Financial Supervisory Authority states that the Bank of Finland shall be liable for any damages arising from an error or omission of the Financial Supervisory Authority as provided in the Tort Liability Act. Chapter 3 section 2 paras 1 and 2 of the Tort Liability Act (412/1974) states that a public corporation shall be vicariously liable in damages for injury or damage caused through an error or negligence in the exercise of public authority. The same liability shall also apply to other corporations that perform a public task on the basis of an Act, a Decree or an authorisation given in terms of an Act. This liability only arises, however, if the performance of the activity or task, in view of its nature and purpose, has not met the reasonable requirements set for it.

[25] I would like to thank Anu Kõve (legal department of the Estonian Financial Supervision Authority) and Kadri Siibak (University of Tartu) for their help regarding the applicable liability regime of the EFSA.

[26] See section 2 of the Act on the Financial Supervisory Authority (No. 278/2008).

**France**
Since reform at the beginning of 2010, financial supervision in France has been carried out by two institutions, namely the *Autorité de Contrôle Prudentiel* (ACP) and the *Autorité des Marchés Financiers* (AMF).[27] Both institutions have no legal personality and are part of the French government. As a result, third parties must hold the State liable for damage caused by the two supervisory authorities. No specific legal rule exists to address their liability. Therefore, normal rules regarding governmental liability apply. The supreme administrative court of France has determined that a governmental supervisory body can only be held liable in cases of gross negligence (e.g. Andenas and Fairgrieve, 2000; Dempegiotis, 2008; De Kezel et al., 2009).

**Germany**
The German financial supervisory authority, *Bundesanstalt für Finanzdienstleistungsaufsicht* (BaFin), is an independent public law body. Its liability is based on § 839 *Bürgerliches Gesetzbuch* (German Civil Code, BGB). Under this article the government can only be held liable by third parties when the task of the government consists in protecting the individual interests of those third parties. To reduce the possibility of individual claims against the supervisory authority, the German government stated, in § 4(4) *Finanzdienstleistungsaufsichtsgesetz* (Financial Services Supervision Act), that BaFin performs its financial supervision only in the general public interest. As a result, in the absence of a specific and targeted duty of care, BaFin is immune from claims by third parties (e.g. Andenas and Fairgrieve, 2000; Dempegiotis, 2008; De Kezel et al., 2009).

**Greece**[28]
Since 2011 financial supervision has been carried out by two public authorities, namely the Bank of Greece (BoG) and the Hellenic Capital Markets Commission (HCMC). There are no specific provisions in Greek law regulating the (third party) liability of these financial supervisors. Third parties may thus hold the institutions liable for shortcomings in their supervisory role based on article 914 of the Greek Civil code read in conjunction with articles 105 and 106 of Greek Law 2783/1941. Article 105 states:

*The State shall be liable and shall pay compensation for illegal acts or omissions of State bodies in the course of exercise of state authority appointed to them, unless the act or omission was in breach of a provision intended to benefit common interest. Without prejudice to special provisions regarding the*

[27] The ACP was formed through the merger of existing licensing and supervisory authorities that supervised the bank and insurance industries (the *Commission Bancaire* (Banking Commission), the *Autorité de Contrôle des Assurances et des Mutuelles* (Insurance and Mutual Insurance Societies Supervisory Authority), the *Comité des Établissements de Crédit et des Entreprises d'Investissement* (Credit Institutions and Investment Firms Committee) and the *Comité des Entreprises d'Assurance* (Insurance Companies Committee). See European Central Bank (2010).
[28] I would like to thank Tsolakidis Zafeiris, Eugenia Dacoronia, Sotiris Dempegiotis and Vera Lazaridi for their help in describing the Greek situation.

*liability of ministers, the liable natural persons serving in the State bodies shall be liable jointly and severally with the State.*

In addition, article 106 states that 'the liability in the previous article shall apply with regard to the liability of municipalities, communities and other legal entities of public law in respect of acts or omissions of bodies operating under their management'. The HCMC (Law 1969/1991) is a legal entity of public law and therefore falls directly within the scope of articles 105 and 106. The BoG is a legal entity of private law. However, due to the fact that the BoG acts as both a commercial bank and a supervisor (exercising State authority) it is considered as a 'legal person of mixed character' by Greek jurisprudence. It is therefore subject to articles 105 and 106 of Greek Law 2783/1941 as well. Based on article 105, it would appear that the applicable criterion to establish third party liability is an illegal act or omission in the course of exercise of state authority, in our case, financial supervision. The criterion 'illegal act or omission' falls under the category of no-fault liability.[29]

**Hungary***[30]***

The Hungarian Financial Supervisory Authority (HFSA) is responsible for the supervision of the financial sector in Hungary (European Central Bank, 2010). Due to the fact that there is no specific law dealing with the liability of the HFSA, its third party liability is based on the Hungarian Civil Code of 1959. Section 349 (1) of this code states that 'liability for damages caused within the jurisdiction of government administration shall be established only if the damage can not be abated by common legal remedies or the aggrieved person resorts to the ordinary legal remedies for the abatement of damages'. Section 339 (1) provides the general rule regarding the applicable liability criterion, namely, that 'a person who causes damage to another person in violation of the law shall be liable for such damage. He shall be relieved of liability if he is able to prove that he has acted in a manner that can generally be expected in the given situation'. The latter sentence implies the applicable standard of care. Based on these sections it seems that the liability of the HFSA is based on a negligence rule. However, while there have been several cases in the past where consumers sued the HFSA for negligence committed during supervision, the liability of the HFSA was not established in any of them.

**Ireland***[31]***

With effect from 1 October 2010, the Central Bank Reform Act created a new single unitary body – the Central Bank of Ireland (CBI) – responsible for both central

[29] See also article 914 of the Greek Civil Code according to which a person who through his fault has caused in a manner contrary to the law prejudice to another shall be liable for compensation.

[30] I would like to thank Laszlo Seregdi for his helpful comments regarding the Hungarian financial supervisory liability regime.

[31] I would like to thank Eoin Quill and the Central Bank for their help with describing the Irish situation.

banking and financial regulation.[32] The new structure replaced the previous related entities, the Central Bank and the Financial Services Authority of Ireland (CBFSAI) and the Financial Regulator. With regard to the third party liability of the CBI for actions or omissions in its supervisory role, the following can be mentioned: section 33AJ of the Central Banking Act is the relevant statutory provision which deals with the liability of the CBI (previously the CBFSAI). This section provides that the CBI 'is not liable for damages for anything done or omitted in the performance or purported performance or exercise of any of its functions or powers, unless it is proved that the act or omission was in bad faith'. Therefore, the CBI is only liable in cases of bad faith (Doherty & Lenihan, 2005).

**Italy**[33]

Italy has four financial supervisory authorities, namely the Bank of Italy, the Supervisory Authority for Private Insurance and Undertakings and Insurance Undertakings of Public Interest (Isvap), the Supervisory Authority for Pension Funds (Covip) and the National Commission for Listed Companies and the Stock Exchange (Consob). The liability of these authorities is outlined in article 24(6) of the Law 28 of December 2005[34] and states that 'in supervising financial activities the Authorities listed by subsection 1 (Banca d'Italia, Consob, Isvap and Covip) as well as the Antitrust Authority, their employers and staff are held responsible for damages caused by gross negligence or intention'. It is worth mentioning that before this amendment, the (third party) liability of financial supervisory authorities was based on the general rule of tort law stated in article 2043 of the Italian Civil Code, which provides for a negligence liability rule (e.g. Rossi, 2003; Scarso, 2006).

**Latvia**

Since 2001, the Financial and Capital Market Commission (*Finanšu un kapitāla tirgus komisija*, FKTK), an autonomous public institution, has been responsible for supervision over the Latvian financial sector. Its liability has been established in the Law on Credit Institutions. Article 111(6) of this Law states:

*The Financial and Capital Market Commission is responsible for damage caused to a third party by the Financial and Capital Market Commission's actions in fulfilling its statutory functions only in the case where the Financial and Capital Market Commission has deliberately acted unlawfully or with gross negligence.*

Based on this article, the FKTK can be placed in the 'gross negligence' category.

[32] See Central Bank Reform Act (NO. 23/2010).
[33] I would like to thank Elena Bargelli for her help in describing the Italian situation.
[34] As amended by legislative decree of 29 December 2006, No. 303, article 4, subsection 3, lit d.

**Lithuania**[35]

Since 2012, the Bank of Lithuania (BoL) has been responsible for supervision over the financial sector in Lithuania.[36] Article 46[1] (1) of the Law on the Bank of Lithuania 1994 (No. I-678 as last amended by No. XI-557) states:

*The damage caused by the illegal actions of the Bank of Lithuania or Bank of Lithuania staff in relation to the performance of the supervisory function of credit institutions and payment institutions shall be reimbursed only in the case where the person who has suffered the damage proves the Bank of Lithuania or Bank of Lithuania staff guilty of such damage.*

The objective criterion 'illegal actions' indicates a no-fault liability rule. One should notice, however, that there has been no case law in Lithuania in which the (past and present) Lithuanian financial supervisory authorities have been held liable.

**Luxembourg**

All financial intermediaries and markets in Luxembourg are under the supervision of the *Commission de Surveillance du Secteur Financier* (CSSF), which commenced its activities on 1 January 1999, except for the insurance sector, which is under the jurisdiction of the *Commissariat aux Assurances* (CAA). The third party liability of the CSSF is outlined in article 20(2) of the Law Creating a Commission for the Supervision of the Financial Sector (1998). This article states that third parties can only hold the CSSF liable when the damage is caused by gross negligence (*une négligence grave*) on the part of the CSSF. Third party liability of the CAA is based on article 24 of the Law on the Insurance Sector (1991). Under this article the State is responsible for the actions taken by the CAA and third parties can only hold the State or the CAA liable in cases of gross negligence (*une négligence grave*).

**Malta**

The Malta Financial Services Authority (MFSA) is the sole supervisor for financial services in Malta. Paragraph 29 of the Malta Financial Services Act (Act XXXIV 1988) limits the liability of the MFSA to acts in bad faith: The Authority, the Board of Governors, the Coordination Committee, the Supervisory Council, the Board of Management and Resources, the Legal Office and the officers and employees of the Authority shall not be liable in damages for anything done or omitted to be done in the discharge or purported discharge of any function under this Act, unless the act or omission is shown to have been done or omitted to be done, as the case may be, in bad faith.

[35] I would like to thank Darius Bugailiskis and Ciceniene Rasa for their help in describing the Lithuanian situation.
[36] See
htttp://www.lb.lt/supervision_service_was_established_at_the_bank_of_lithuania_as_a_part_of_the_introduction_of_the_new_financial_market_supervision_model.

**The Netherlands**

The Financial Market Authority (AFM) and the Dutch Central Bank (DNB) are responsible for financial supervision in the Netherlands. Because there is no specific law dealing with the liability of these supervisory authorities, liability is based on normal tort rules, specifically article 6:162 of the Dutch Civil Code. Section 1 of this article states that 'a person who commits a tortious act (unlawful act) against another person that can be attributed to him, must repair the damage that this other person has suffered as a result thereof'. An unlawful act is defined (section 2) as 'the violation of a right and an act or omission breaching a duty imposed by law or a rule of unwritten law pertaining to proper social conduct'. Jurisprudence and publications on the topic of financial supervisory liability clearly indicate that the standard for financial supervisors is 'reasonable care'. But what is meant by reasonable care? The Supreme Court of the Netherlands pointed out in the *Vie d'Or* case that, in order to determine whether financial supervision complies with the standards of reasonable care, all circumstances of the individual case have to be taken into account.[37] These circumstances include the 'nature' of financial supervision, the fact that financial supervisors have discretionary powers in order to fulfil their supervisory duties, and the fact that financial supervisors face the difficult task of taking into account both the interests of the supervised institutions and individual consumers (the supervisor's dilemma). The applicable liability criterion for the DNB and AFM is therefore negligence (Giesen, 2005; Dijkstra, 2009; Busch, 2010).[38]

**Poland**[39]

Poland has two authorities that perform financial supervision, namely the Polish Financial Supervision Authority (PFSA) and the National Bank of Poland (NBP). The liability of these two authorities is dealt with in the Act of Financial Market Supervision of 26 July 2006. Article 33(6) of this Act formulates the following amendment to the Act on the National Bank of Poland (August 1997):

*Article 133.4 shall read as follows: The Financial Supervision Authority, the National Bank of Poland and the persons responsible for carrying out banking supervision activities shall have no liability whatsoever for damages resulting from any action or omission connected with the exercise of supervision by the Financial Supervision Authority over the activities of banks, branches and representative offices of foreign banks, branches of credit institutions and the exercise of supervision, pursuant to the provisions of the Electronic Payment Instruments Act of September 12th 2002, over*

[37] See sections 3.8–3.12 of the conclusion of A-G Timmerman with regards to the outcome of the *Vie d'Or* case (Supreme Court of the Netherlands, 13 October 2006, No. C04/279HR).

[38] As this chapter was originally published in 2012 it does not take into account the change of legislation that took place in the Netherlands as of 1 July 2012. As of that date, the liability of the Dutch financial supervisory authorities was limited to cases of gross negligence and/or bad faith. See also Section 2.5 of this chapter.

[39] I would like to thank Ewa Bagińska and Katarzyna Ludwichowska for their help in describing the financial supervisory liability regime in Poland.

*electronic money institutions and branches of foreign electronic money institutions, where such action or omission is compliant with statutory regulations.*

Liability of the PFSA and NBA is thus based on their non-compliance with statutory regulations; in other words, their 'unlawfulness'. Based on this wording alone it is difficult to categorize the liability, and one thus needs to look further. Due to the fact that performing financial supervision can be considered exercising public authority, the liability of the PFSA and NBP can be based on the general rule on liability for damage caused by the exercise of public authority as stated in article 417 of the Polish Civil Code. Article 417 § 1 states that 'liability for damage caused by illegal action or omission in the course of exercise of public authority rests with the State Treasury, a local authority or other legal person who exercises authority conferred upon it by law'. In order for liability to arise, it is sufficient that the public authority's conduct is illegal (contrary to law). This means that liability for damage caused by the exercise of public authority is independent of fault.[40]

**Portugal*[41]***

Currently, three authorities supervise the financial sector in Portugal: the *Banco de Portugal* (Central Bank of Portugal, BdP), the *Comissão do Mercado de Valores Mobiliários* (Securities Market Commission, CMVM) and the *Instituto de Seguros de Portugal* (Portuguese Insurance Institute, ISP). There are no specific rules regarding the (third party) liability of these authorities. Article 22 of the Constitution of Portugal 1976 states:

*The State and other public bodies are jointly and severally liable under civil law for the members of their organs, their officials, and their staff members, for actions or omissions in the exercise of their functions or caused by such exercise which results in violations of rights, freedoms, or safeguards or in damage to another party.*

Law No. 67/2007 of 31 December 2007 deals more specifically with the liability of the State and other public entities. Since the above mentioned supervisory authorities can be considered public entities, as they are exercising public authority (performing financial supervision), their liability is based on this law, or, more particularly, on article 7 which states that '[t]he State and other legal public persons are solely responsible for any damage that results from unlawful acts or omissions, by the holders of its organs, officials or agents, in the exercise of administrative function.' In addition, article 7(3) states that:

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[40] Besides this no-fault regime, the liability of the Polish financial supervisory authorities can also be based on a fault-based liability criterion as stated in art 415 of the Polish Civil Code. In such an action non-compliance with statutes would typically amount to negligence (objective standard of fault as applied to professionals).

[41] I would like to thank Jorge Sinde Monteiro and André Pereira for their helpful comments regarding the Portuguese situation.

*The State and other legal public persons are still responsible when the damage has not been the result of the specific conduct of a public organ, official or agent, or when it is not possible to prove the personal act or omission, but when the damage must be attributed to an abnormal functioning of the authority.*

Based on the latter article, we can conclude that the applicable liability criterion for the Portuguese financial supervisory authorities is negligence.

**Romania**

Supervision over the Romanian financial sector is performed by three authorities, namely the National Bank of Romania (NBR), the National Securities Commission (*Comisia Națională a Valorilor Mobiliare,* CNVM) and the Insurance Supervisory Commission (*Comisia de Supraveghere a Asigurarilor,* CSA). Each of these authorities is categorised as an autonomous administrative authority with a legal personality. Despite several attempts to gather information about the liability of these authorities, it was not possible to gather sufficient information to fully describe the situation in Romania.

**Slovenia**[42]

In Slovenia there are three main national financial supervisory authorities: the Bank of Slovenia (responsible for bank institutions), the Slovenian Securities Market Agency (responsible for investment firms) and the Insurance Supervision Agency (controlling insurance companies, intermediaries and agents). As there are no specific provisions dealing with the liability of these financial supervisory authorities, their liability is based on the Slovenian Code of Obligations (No. 001-22-117/01). Article 131(1) of the Code states that 'any person that inflicts damage on another shall be obliged to reimburse it, unless it is proved that the damage was incurred without the culpability of the former'. Article 135 defines culpability as a case where damage was caused intentionally or by negligence without further explanation of either of these elements of fault.

**Slovakia**[43]

Since 2006 the National Bank of Slovakia (NBS) has been the single integrated financial supervisory authority responsible for the supervision over the Slovakian financial sector. Regarding the third party liability of the NBS, article 43(1) of the Act on Supervision of the Financial Market No. 747/2004 Coll (as amended) states that 'liability for damage caused by the National Bank of Slovakia during the exercise of public authority within the scope of supervision of the financial market shall be stipulated by a separate law'. This law refers in turn to Act No. 514/2003 Coll on

[42] I would like to thank Vida Hočevar and the Securities Market Agency (ATVP) for their helpful comments regarding the Slovenian situation.

[43] I would like to thank Anton Dudlak of the NBS for his help with describing the situation in Slovakia.

Liability for Damage Caused during the Exercise of Public Authority, article 4(1)(g) of which states that 'the Slovak State is liable for all possible claims arising due to damage caused by activities performed by the NBS in the exercise of its supervisory tasks ("maladministration")'. Article 9(1) defines the concept of maladministration as the breach of obligations of a public authority to take action in exercising its public authority. Based on the above mentioned articles, a rule of no-fault can be considered the applicable liability criterion.

**Spain**[44]

The Spanish supervisory system includes, in total, three institutions (European Central Bank, 2010): the *Banco de España* (Bank of Spain), the *Comisión Nacional del Mercado de Valores* (National Securities Market Commission) and the *Dirección General de Seguros y Fondos de Pensiones* (General Insurance and Pension Funds Directorate). There are no specific legal provisions regarding the liability of the above mentioned supervisory authorities. As they are all public bodies subject to the Act on the Legal Regime of Public Administrations and General Administrative Procedure of 1992 (LRJAP),[45] their liability is based on the rules of State liability. Article 139 of the LRJAP states that 'individuals are entitled to compensation from the State regarding damages that are the result of the normal or abnormal functioning of public services'. The liability of the financial supervisory authorities in Spain can therefore be classified as 'no-fault'. However, it is important to notice that their liability goes beyond the objective liability for unlawful or illegal conduct that is found in other countries in this category.[46] Thus, the State is liable unless the victim is expected to endure the damage or no causal link can be found between the public body's conduct and the victim's harm. There are currently some important pending claims regarding recent financial scandals involving State authorities and public bodies. In the case *Afinsa/Forum Filatelico*, several decisions of the *Audiencia Nacional* exonerated CNMV, Bank of Spain and the Ministry of Economy from liability.[47] However, appeals against these decisions will come before the Supreme Court over the next few years.

**Sweden**[48]

Since 1991, the Swedish Financial Supervisory Authority (SFSA), or *Finansinspektionen*, has been the single integrated supervisory authority responsible for supervision over the Swedish financial sector (European Central Bank, 2010). The SFSA is a government central administrative authority that falls under the Swedish Ministry of Finance. Since no specific rules exist regarding the liability of the SFSA, its liability is based on the Swedish Tort Liability Act of 1972 (1972:207). Chapter 3, section 2 of

[44] I would like to thank Jordi Ribot Igualada for his help regarding the Spanish situation.
[45] Law 30/1992, *de 26 de noviembre, de régimen juridico de las Administraciones Públicas y del Procedimiento Administrativo Común*.
[46] The liability of the Spanish financial supervisory authorities can be considered 'strict' in the classic sense.
[47] See for instance http://www.tradersnarrative.com/a-sad-end-for-the-afinsa-fraud-saga-3625.html.
[48] I would like to thank Mårten Schultz for his remarks on the Swedish situation.

this law stipulates that the Government or a municipality is liable for damages caused by public bodies through the negligent exercise of public authority. Thus, when it comes to the liability of public bodies (in our case the SFSA), the general liability criterion of negligence (*culpa*) applies.

**United Kingdom**
Since 2000, the supervision of the financial sector in the United Kingdom has been performed by the Financial Services Authority (FSA). The FSA is an independent public law body and its liability is dealt with in the Financial Services and Markets Act (FSMA) of 2000 (2000 c 8). Schedule 1 para 19 of the FMSA limits the liability of the FSA to 'acts in bad faith' as well as acts that breach Convention rights incorporated into English law by the Human Rights Act 1998 (1998 c 42). As a result, the FSA can be regarded as falling in the 'bad faith' category (e.g. Proctor, 2002; Proctor, 2004; Booth and Squires, 2005; Singh, 2007). It is worth mentioning that the liability of predecessors of the FSA was limited to cases of bad faith by specific legal provisions contained in the Financial Services Act 1986 (1986 c 60) and the Banking Act 1987 (1987 c 22) (Tison, 2003).[49]

## *2.3 Comparing the third party liability regimes*

### 2.3.1 Introduction

In this section, a comparison is made between the third party liability regimes of the financial supervisory authorities in the member states of the EU. The comparison of liability regimes can take place on various levels. In practice, since comparing more countries comes at the expense of less information per country, the level of comparison is less detailed than it might otherwise have been. As the scope of this research covers all the member states of the EU, only a quantitative comparison (numerical measurement) has been performed by calculating the relative importance of each pre-defined liability category in the EU.

### 2.3.2 Data analysis

In this chapter the legal rules concerning third party liability from 48 different financial supervisory authorities in the 27 member states of the EU have been examined. It was not, however, possible to find sufficient information on one member state, namely Romania (which has three financial supervisory authorities).

[49] As per 1 April 2013, the Financial Services Act 2013 (FSA 2013) came into force, abolishing the FSA with effect from this date. Its responsibilities were then split between two new authorities (the Prudential Regulation Authority and the Financial Conduct Authority) and the Bank of England. Schedule 4 para 14 of the FSA 2013 limits the liability of these institutions to 'acts in bad faith' as well as acts that breach Convention rights incorporated in English law by the Human Rights Act 1998.

Furthermore, data was only available for one of the four financial supervisory authorities in Cyprus. The data in this research therefore reflect 42 supervisory authorities (or 88% of all member state supervisory authorities) while it fully reflects the third party liability situation in 25 member states (or 93%).

When we take a closer look at the data from the 42 financial supervisory authorities, we find that 21 supervisory authorities (50%) are governed by specific liability rules. 'Specific liability rules' refers to the idea that national legislation contains specific provisions which address the liability of supervisory authorities. In most cases, these provisions introduce limitations to third party liability by introducing a standard of gross negligence (applied to ten supervisory authorities), bad faith (applied to four supervisory authorities) or immunity (applied to one supervisory authority). Regarding the six other supervisory authorities, the provisions contain a reference to general liability rules. Regarding these latter cases and the cases where no specific legal provision exists (total of 27 financial supervisory authorities),[50] it was more difficult to determine which liability standard applied.

As described above, legal literature was used to determine the applicable liability standard. In this way it was possible to determine the liability standard of five[51] of the 27 financial supervisory authorities. To determine the liability standard of the remaining 22 financial supervisory authorities, national laws that deal with governmental liability or the liability of public authorities were examined. In order to review the outcomes of the research, empirical research was conducted in terms of which at least one national expert per member state (legal scholars or members of the financial supervisory authorities) was consulted. The outcomes of the research are summarised in detail in Appendix 1 of this study.

### 2.3.3 Comparing third party liability regimes

In order to compare the third party liability regimes, a quantitative analysis of the data from section 2.2 was made. The first step was to add up the number of supervisory authorities per liability category followed by a calculation of the weight (in percentage terms) of each category. This numerical measurement is based on the assumption that every member state has equal weight (one vote per member state). One could question, however, whether this is a fair reflection of the relative importance of each member state within the EU. It seems more appropriate to use some kind of weighting factor. Weighting the importance of member states can be effected by using various criteria. The most commonly used criteria to measure the relative importance of member states are population size and gross domestic product (GDP), which are

[50] Excluding the six financial supervisory authorities for which it was not possible to find sufficient information. No specific liability provision exists for these cases either.
[51] These five are: AMF and ACP (France), Bafin (Germany), AFM and DNB (Netherlands).

thus used in this analysis. For a detailed outcome of this analysis, readers should refer to Appendices 2, 3, and 4 of this study. Table 1 gives a comprehensive overview of the outcome based on the mentioned criteria.

**Table 1: Overview of third party financial supervisory liability categories in the EU.**

| **Category** | *Equally weighted ('one vote per member state')* | *Based on population size* | *Based on GDP* |
|---|---|---|---|
| No-fault | 24% | 24% | 16% |
| Negligence | 26% | 12% | 14% |
| Gross negligence | 19% | 28% | 32% |
| Bad faith | 17% | 14% | 15% |
| Immunity | 7% | 18% | 23% |
| Unknown | 6% | 4% | 1% |
| **Total** | **100%** | **100%** | **100%** |

What can we conclude from Table 1? First of all, it shows that there is no common or single dominant third party liability regime for financial supervisory authorities in the EU. Negligence (26%) is the most common used liability rule when taking into account 'one vote per member state', while gross negligence (28% and 32%) is the most frequently used liability rule when taking into account population size and GDP. But there is no single liability rule with an overwhelming impact in the EU.

In the discussion regarding financial supervisory liability, the central question is whether financial supervisory authorities should be held liable at all and, if so, under what conditions and subject to what limitations (Athanassiou, 2011). From a European perspective, the answer to the first question seems to be positive as the majority of the financial supervisory authorities can be held liable (see Table 2). Immunity of financial supervisory authorities applies only in Germany and Austria.

**Table 2: Liability versus immunity.**

| Category | *Equally weighted ('one member state, one vote')* | *Based on population size* | *Based on GDP* |
|---|---|---|---|
| Liability | 86% | 78% | 76% |
| Immunity | 7% | 18% | 23% |
| Unknown | 6% | 4% | 1% |
| **Total** | **100%** | **100%** | **100%** |

The second part of the question, namely, under what conditions and subject to what limitations should financial supervisory authorities be held liable, is a bit more difficult to answer. If we consider the categories of gross negligence, bad faith and immunity as more or less formal limitations of liability compared to no-fault and negligence, the following table appears:

**Table 3: Limited third party liability versus non-limited third party liability.**

| Category | *Equally weighted ('one member state, one vote')* | *Based on population size* | *Based on GDP* |
|---|---|---|---|
| No-fault | 24% | 24% | 16% |
| Negligence | 26% | 12% | 14% |
| **Non-limited third party liability** | **50%** | **35%** | **29%** |
| Gross negligence | 19% | 28% | 32% |
| Bad faith | 17% | 14% | 15% |
| Immunity | 7% | 18% | 23% |
| **Limited third party liability** | **44%** | **60%** | **70%** |
| Unknown | 6% | 4% | 1% |
| **Total** | **100%** | **100%** | **100%** |

From Table 3, it becomes clear that there is a big difference between applying the equally-weighted criterion and using the other two weighting criteria. Using the criterion of 'one member state, one vote' results in a figure of 44% for limited third party liability and 50% for non-limited third party liability. From this perspective, limited third party liability is not dominant in the EU. However, if we apply the weighting criteria population size or gross domestic product, the outcome is different. In the case of population size, limiting third party liability has a weight of 60% compared to a weight of 35% for liability non-limited. When using gross domestic product as a weighting criterion, the difference becomes even bigger: 70% for 'limited' and only 29% for 'non-limited'. So when we apply these weighting criteria, limited third party liability can be considered dominant in the EU. This is mainly due to the impact of the third party liability regimes in France, Germany, Italy, and the United Kingdom.

### 2.3.4 A critical note

One should be careful in interpreting this research. Limited third party liability in this research means that (1) a more severe liability standard is introduced (gross negligence or bad faith) or that (2) it has been made impossible for third parties to hold the financial supervisory authority liable (immunity). Compared to ordinary negligence or no-fault liability, these severe additional standards are indeed limitations. However, the behavioural standard (negligence, gross negligence or bad faith) for supervisory authorities is just one of the requirements for holding them liable. Other requirements are, in general, the existence of damage and a causal relationship between the damage and the behaviour of the tortfeasor. The exact borders between the different fault liability categories, especially between negligence and gross negligence, are also difficult to define in practice.

The interpretation of the behavioural standard and other requirements will often differ amongst the member states due to their historical and cultural backgrounds and their policy views as to what can be considered fair, just and reasonable. In practice, this can result in a greater or lesser tendency to impose liability on the financial supervisory authorities. Member states can also limit the impact of third party liability by imposing a liability cap; in that case, the compensation that financial supervisory authorities are obliged to pay when being found liable is set to a fixed maximum amount. As the liability regimes have not been examined in detail in this chapter, the outcome of this research provides only a general indication of the importance of the different liability categories in the EU. In order to provide a more accurate overview, more in-depth research would need to be carried out at member state level.

## *2.4 Conclusion*

The topic of financial supervisory liability is becoming increasingly important from a European perspective due to the on-going process of 'Europeanisation' of financial law and supervision. It is therefore interesting to see how the current liability landscape regarding financial supervisory authorities looks. The outcome of such research could be a starting point for further debate regarding financial supervisory liability, both at a national as well as a European level.

This chapter has provided an overview of the national supervisory third party liability arrangements in the EU and showed the relative importance of the liability categories when taking into account 'one vote per member state', population size and gross domestic product as weighting factors. From this analysis, it becomes clear that most financial supervisory authorities can, formally, be held liable by third parties. Only two member states, Germany and Austria, grant immunity to their financial supervisory authorities. There exists, however, no common approach to financial supervisory liability; none of the individual liability categories has a dominant representation in the total. When taking into account the weighting criteria population size or gross domestic product, limited third party liability (consisting of gross negligence, bad faith or immunity) seems to be more dominant in the EU compared to non-limited third party liability (no-fault or negligence based liability).

It is, however, important to note that this research did not examine all the requirements for holding a financial supervisory authority liable nor did it involve a detailed study of the relevant jurisprudence. The outcome of the research therefore provides only an indication of the relative importance of the different liability categories in the EU. In order to obtain a more accurate overview, in-depth research will need to be carried out for each member state.

### *2.5 Commentary*

As this chapter was originally published in 2012 it does not take into account the change of legislation that took place in the Netherlands as of 1 July 2012. As of that date, the liability of the Dutch financial supervisory authorities was limited to cases of gross negligence and/or bad faith.[52]

Furthermore, as of 1 July 2013, Croatia became the 28th member state of the European Union.[53] Financial supervision in Croatia is carried out by the Croatian National Bank (CNB) and the Croatian Financial Services Supervisory Agency (HANFA). The liability of the CNB is arranged in article 8(2) of the Act on the Croatian National Bank. This article states that the Croatian National Bank, the members of the Council, and employees of the Croatian National Bank shall not be liable for any damage that may arise in the course of exercising supervision and oversight unless the damage has been caused intentionally or by gross negligence. A similar provision has been included in Article 10 of the Act on the Croatian Financial Services Supervisory Agency. As a consequence, the liability of the Croatian financial supervisory authorities is limited to cases of gross negligence and/or bad faith.

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[52] See article 1:25d of the Dutch Act on financial supervision.
[53] See http://ec.europa.eu/enlargement/countries/detailed-country-information/croatia/index_en.htm.

What does the change in Dutch legislation and the additional member state mean for the outcome of this chapter? Table 4 presents a comparison. The columns 'Before 1 July 2012' show the outcome of the original research, while the columns 'After 1 July 2012' show the outcome including the change of legislation in the Netherlands and the inclusion of Croatia.

**Table 4: Comparing the liability categories before and after 1 July 2012**

| Category | *Equally weighted* | | *Based on population size* | | *Based on GDP* | |
|---|---|---|---|---|---|---|
| | *Before 1 July 2012* | *After 1 July 2012* | *Before 1 July 2012* | *After 1 July 2012* | *Before 1 July 2012* | *After 1 July 2012* |
| No-fault | 24% | 23% | 24% | 23% | 16% | 15% |
| Negligence | 26% | 21% | 12% | 8% | 14% | 9% |
| **Non-limited third party liability** | **50%** | **45%** | **35%** | **32%** | **29%** | **24%** |
| Gross negligence | 19% | 26% | 28% | 32% | 32% | 37% |
| Bad faith | 17% | 16% | 14% | 14% | 15% | 15% |
| Immunity | 7% | 7% | 18% | 18% | 23% | 23% |
| **Limited third party liability** | **44%** | **49%** | **60%** | **64%** | **70%** | **75%** |
| Unknown | 6% | 6% | 4% | 4% | 1% | 1% |
| **Total** | **100%** | **100%** | **100%** | **100%** | **100%** | **100%** |

Table 4 makes clear that the change of legislation in the Netherlands and the inclusion of Croatia in the analysis does not significantly influence the overall outcome as presented in this chapter. From an equally weighted perspective, the balance has shifted from non-limited third party liability towards limited third party liability. As this shift is relatively small, limited third party liability still can not be considered dominant from this perspective. However, when applying population size and GDP as weighting criteria, limited third party liability becomes even more dominant in the EU.

# 3 Liability of financial supervisory authorities: Defensive conduct or careful supervision?

## *3.1 Introduction*

Should financial supervisory authorities be liable to third parties if they conduct their supervisory tasks in a negligent manner? In light of the recent financial crisis, this question seems to be more relevant than ever. The answer differs however, between the member states of the European Union. A number of countries, including the Netherlands, Denmark, Finland, France and Hungary, submit their financial supervisory authorities to normal liability rules (Tison, 2003). On the other hand, countries like the United Kingdom, Ireland and Estonia, have statutory immunities in place to protect their financial supervisory authorities from being sued.[54] In other jurisdictions, it has been explicitly recognised that a supervisory authority owes his duties to the public as a whole, and not to individual investors. In the absence of a specific and targeted duty of care, the supervisory authority can not be liable for the loss of deposits in this type of case (Proctor, 2002; Proctor, 2004).[55] It is important to note that all these protections are in line with the recommendations of the Basel Committee on Banking Supervision (Basel Committee on Banking Supervision, 2006).

But why do these countries have such different views? In order to understand these different views, we have to take a closer look at the underlying arguments. The need for financial supervisory authority protection seems to be based on the chilling effect or defensive conduct that even the threat of litigation can have on the performance of a financial supervisory authority's work. It has been suggested that imposing liability would inhibit the effective operations of a financial supervisory authority, thus leading to an allocation of resources to unnecessary and wasteful practices aimed at averting litigation (e.g. Tison, 2003; Proctor, 2004; Booth & Squires, 2005; Singh, 2007; Delston & Campbell, 2008). On the other hand, submitting financial supervisory authorities to normal tort rules can be based (at least to a large extent) on the preventive function of tort law, in which the threat of being held liable gives financial supervisory authorities an incentive to perform the tasks assigned to them with (greater) care (e.g. Shavell, 2005; Van Dam, 2006a; Giesen, 2006; Boom, 2006; Visscher, 2008).[56] As a consequence, these incentives will lead to a situation where the

[54] See for example Schedule 1, section 19(1) of the Financial Services and Markets Act (FMSA) 2000 (United Kingdom), article 4 (2-3) Financial Supervision Authority Act (FSAA) and article 58 FSAA in combination with article 13 (3) of the State Liability Act (Estonia), section 25A Central Bank of Ireland Act 1997 (Ireland). The term immunity seems to indicate that these financial supervisory authorities can not be sued at all. However, this is not the case. Exceptions to this immunity are formed by acts of omissions in bad faith (see for instance Schedule 1, section 19(3) FMSA 2000 for the UK situation).

[55] This refers to the concept of 'relativity' or 'proximity'.

[56] Besides tort law there are also other instruments which, in theory, could give financial supervisory authorities incentives for taking (greater) care. Examples of these instruments are public law, criminal law and threat of reputation

primary injurer (the supervised financial institution) also causes fewer losses, since the financial supervisory authority will require more care from the primary injurer so as to avoid liability (Giesen, 2006).[57] In this manner, tort law could lead to more careful financial supervision.

The obvious question that arises is which view on the liability of financial supervisory authorities is the most likely to occur? The goal of this chapter is to evaluate the role of liability rules in preventing negligent financial supervision, and in particular, to examine the incentive effects of liability rules on the behaviour of financial supervisory authorities. The central question of this chapter focuses on the most likely effect of tort law on the behaviour of financial supervisory authorities. In other words, will the application of tort law indeed lead to defensive conduct, or is it an adequate mechanism to regulate financial supervisory authorities? To answer this research question, I focus only on the third party liability of financial supervisory authorities. This kind of liability will often come in view following the insolvency or bankruptcy of a financial institution (Tison, 2003).[58]

Debtors, for example, who have not been able to fully recover their claims out of bankruptcy, or after reimbursement by the deposit guarantee or investor compensation system, may try to get compensation from financial supervisory authorities by holding them liable on grounds of shortcomings in their supervisory role (Tison, 2003). This act seems like a rather obvious move, considering that financial supervisory authorities, as part of the government, have deep pockets and therefore form a good alternative (compared with a bankrupted financial institution) to provide compensation for losses. As stated before, we need to examine the impact of tort law on the behaviour of financial supervisory authorities to answer the central question of this chapter.

To do this, I use a positive economic analysis. This kind of economic analysis tries to predict the incentive effects of liability rules on the behaviour (the chosen level of care) of, in this case, financial supervisory authorities, and is therefore a suitable analysis tool.[59]

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loss.

[57] It is important to notice that not all accidents will be avoided due to the presence of tort liability. While it was never meant to deter accidents entirely, tort law is aimed to lessen the number and severity of accidents that would otherwise occur.

[58] This type of liability occurs most frequently and receives a lot of media attention. Examples include Vie d'Or, Befra, Van der Hoop (The Netherlands), BCCI (UK) and Banque Phocéenne (France).

[59] Positive economic analysis has to be distinguished from a normative economic analysis. The latter goes one step further and makes policy recommendations based on the consequences of various policies. The key concept for normative analysis is efficiency. However, in this chapter, I give no recommendations based on the outcome of my positive economic analysis. My only goal is to show the readers, from a theoretical point of view, the most likely impact of tort law on the behaviour of financial supervisory authorities.

The chapter is organized as follows. Section 3.2 describes a basic economic model of third party supervisory liability. This model is derived from common law and economics literature and shows how tort law, in theory, can encourage supervisors to exercise careful supervision. This part presents a good understanding about the basic law and economic analysis of tort law. However, this basic model uses relatively simple assumptions, which are not in accordance with the real world in which financial supervisory authorities operate. Financial supervisory authorities operate in a context with specific characteristics that are likely to influence the deterrence impact of tort law.

Section 3.3 will examine these specific characteristics more closely. The Dutch financial supervisory authorities will be used as an example for identifying these characteristics.[60] With the use of literature regarding Dutch financial supervisory authorities, I shall identify the specific characteristics which deviate from the conditions mentioned in the basic economic model. For all of these characteristics, I show, with the use of law and economics literature, whether the proclaimed deterrence effect of tort law is positively or negatively influenced. From this analysis, it becomes clear whether a characteristic leads to under-deterrence, over–deterrence, or has a neutral effect. However, the magnitude of these effects is not clear. Because it is very difficult (if not impossible) to measure the exact magnitude of these effects, a qualitative judgement will be made to obtain the most probable impact of tort law on, in this case, the behaviour of Dutch financial supervisory authorities.

Section 3.4 contains the conclusion, in which the central question of this chapter is answered from a law and economics perspective.

## *3.2 A basic economic model of third party financial supervisory liability*

### 3.2.1 Why do we have financial supervisory authorities? A short economic background

Before entering into a detailed analysis of financial supervisory liability, I will first provide a general economic background regarding financial supervisory authorities and their liability. The first question that arises is why financial supervisory authorities are needed at all. The answer to this question can best be described by the term market failure.[61] Financial markets, like many other markets, are influenced by market imperfections (Heremans, 2000). A good example of such market imperfection is the information asymmetry between financial institutions and their customers. Individual consumers lack the knowledge, information and time to assess the solvability of

[60] Many of these characteristics will also apply to other financial supervisory authorities in Europe.
[61] A lawyer being asked the same question would probably answer 'consumer protection'.

financial institution themselves. Even if individual consumers would be able to do this, it would not be efficient for them. Therefore, specialised institutions engaged in the task of supervision would be more effective. Another market imperfection is caused by so called 'externalities,' which are not internalized by financial institutions. When I say externalities, I am referring to the following: Financial markets and institutions are much more interconnected and characterized by 'herd behaviour' compared with other sectors of the economy. Bankruptcy of one institution may easily spill over to others and endanger the whole financial system, as has been the case of recent times (Heremans, 2000). Individual financial institutions do not take these externalities into account. As a consequence, they are likely to engage in riskier strategies compared to situations in which they *would* take these externalities into account.

To overcome the above mentioned causes of financial market failure, the government can use a number of instruments. One important instrument is regulation. Financial markets are considered to be the most regulated markets in the world. Regulation can be seen as an instrument giving financial institutions incentives to behave in line with regulation. The question of who monitors compliance with the regulation must also be answered. It is not likely that individual consumers are capable of doing this, given the already mentioned lack of knowledge, time and information. Therefore, financial supervisory authorities are established to monitor financial institutions. They have more knowledge, time and instruments than individual consumers to adequately monitor these financial institutions. Furthermore, given the importance of the financial markets for the overall economy, so called safety nets are also needed, namely Lender Of Last Resort (LOLR) and deposit insurance systems (Heremans, 2000; Singh, 2007). These governmental instruments can, however, lead to moral hazard problems. In providing alternative safety nets, it tempts financial institutions to pursue high risk investment strategies at the expense of the government. Also, when they are covered by deposit insurance, depositors have fewer incentives to monitor and discipline financial institutions themselves. As a consequence, government safety nets help solve risk problems, but only by creating other problems. Another factor impacting the incentives for financial institutions is the fact that a lot of these institutions are 'too big to fail'. By this I mean the idea that the collapse of these financial institutions would have such a huge impact on the (world) economy, governments would likely intervene in order to avoid such a breakdown. Knowing the government will intervene, these large financial institutions may pursue riskier strategies. To overcome these problems, interventions by regulation and supervision are necessary (Heremans, 2000).

### 3.2.2 Financial supervisory liability: An economic perspective

Having discussed the main reasons for the existence of financial supervisory authorities, it is now time to focus on their liability with regard to third parties. From a law and economics perspective, the liability of the primary wrongdoer, in this case the supervised financial institution, is most efficient. Why? This actor is in the best position to prevent damages (De Mot, 2001). So, why then, should we hold financial supervisory authorities liable? The economic answer to this question is that tort law does not always give the most efficient incentives to supervisees. There are two main reasons for this inefficiency. First, the threat of tort law for potential injurers is not always severe. Losses for the individual victim may be so small that the costs of a suit, including opportunity costs, would make it too expensive or too much trouble to sue. The second reason can be found in the so called 'judgment proofness' of the potential injurer (Giesen, 2006). An injurer is often not a solvent party and, thus, frequently judgement proof. Faced with liability, the actor is not able to put up the total cost of liability if forced to pay, and he knows this well in advance. As a consequence, the potential injurer does not take into account the full costs of his behaviour, leading to a level of precaution that lies beneath the required level.

It becomes clear that tort law does not always give potential injurers sufficient incentives to behave carefully. As such, we need other mechanisms for creating such incentives. One solution is the use of supervisory authorities. Through financial supervision, the supervised financial institution gets an incentive to behave carefully, as deviant behaviour will be punished by the financial supervisory authority. However, this leads to one important question, namely, who regulates the financial supervisory authority? Like all other actors in society, financial supervisory authorities should also have incentives to perform the tasks assigned to them with care. In theory, tort law can give such an incentive. The threat of being held liable could give the financial supervisory authorities incentives to make optimal use of their instruments in order to prevent unlawful conduct by the supervised financial institutions. Financial supervisory liability is, in this way, justified by the fact that these authorities also need some kind of incentive to act carefully. How does this mechanism work in theory? What conditions have to be met in order to achieve this kind of incentive from tort law? And, more importantly, does it work?

The following sections will outline a basic economic model of financial supervisory liability which clarifies how the deterrent impact of tort law works. The first step in analysing the impact of tort law on the behaviour of financial supervisory authorities is the description of a basic economic model which predicts the incentive effects of various liability rules under a set of assumptions.[62] The next step is to identify and examine the specific characteristics of financial supervisory authorities which are likely to influence the deterrent impact of tort law. Relaxing some of these assumptions, and to replace them with the identified characteristics, may lead to a more realistic model

[62] The basis economic model of tort law is mainly derived from Cooter & Ulen (2007).

and, as a consequence, to better insights and a more accurate outcome. The latter is done in Section 3.3 of this chapter.

### 3.2.3 Financial supervisory liability

As mentioned in the introduction, this chapter focuses on third party financial supervisory liability which arises from the bankruptcy of a financial institution. An important characteristic of this kind of liability is the fact there are three actors involved (instead of two), namely the supervised financial institution, the consumer and the financial supervisory authority itself (see Figure 2).[63]

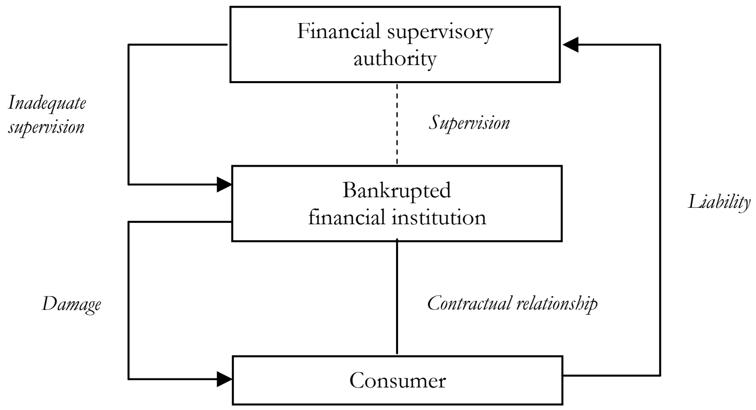


**Figure 2: Third party financial supervisory liability.**

The supervised financial institution plays an important role because financial supervisory liability will only arise when consumers incur damage from the unlawful behaviour of a financial institution; in this case, the behaviour which led to the bankruptcy of the financial institution. As a consequence, the liability of financial supervisory authorities is not only dependent on a breach of their own duty of care, but also on the fact of whether the supervised financial institution caused damage to their customers. The bankruptcy of a financial institution can therefore be seen as the trigger for suing the financial supervisory authority.

[63] Notice that this is the situation in which a financial institution goes bankrupt. Other forms of third party liability are not dealt with in this chapter.

### 3.2.4 Basic model

In describing a basic economic model of third party financial supervisory liability, we have to make some essential assumptions. The first assumption is that the probability of unlawful behaviour by a supervised financial institution, which will be denoted as p, decreases with increases in the care level (quality) of supervision by the financial supervisory authority, which I denote as S.[64] In other words, financial supervision leads to a smaller chance that financial institutions subject to supervision will behave unlawfully and cause damage (Tison, 2003). This assumption is, in my opinion, rather obvious, since reducing unlawful behaviour from the side of financial institutions is one of the main arguments for having financial supervisory authorities. For the purpose of my analysis, it is also assumed that unlawful behaviour by a financial institution leads (in the end) to its bankruptcy and, as a consequence, to a certain amount of damage for the consumer (debtor).[65]

Let D denote the monetary value of damage from the bankruptcy. D multiplied by p equals the expected monetary damage. Like p(S), the expected harm, p(S)D, is a decreasing function of care S. Increasing the level of care decreases the probability of a tort occurring at a diminishing rate. Thus, taking care also offers benefits of damage prevention. However, the crucial concept of care is that it possesses the characteristic of being costly; taking care costs money. In fact, more care leading to a better quality of supervision can only be achieved at higher costs. So the next assumption I make in my basic model is the fact that careful financial supervision costs € m per unit. To keep it simple, it is assumed that m is constant and does not change with the amount of supervision S. The line mS, equal to the total amount spent on careful financial supervision, is therefore a straight line. Now, the total social costs of accidents can be defined as the sum of the cost of careful supervision (mS) and the cost for expected damage (p(S)D). This can be denoted as SC = mS + p(S)D. See Figure 3 for a graphical illustration of the basic model.

[64] Note that not only the quality of supervision, but also the amount of supervision, reduces the risk that financial institutions cause damage through unlawful behaviour. In this chapter, I assume that the total amount of supervision is stable and that the quality of supervision is a variable that can be influenced.

[65] Notice that unlawful behaviour does not always lead to instant damage. Suppose a bank does not comply with the applicable prudential regulation. In the short term, it is unlikely that this will cause damage to their clients. However, the risk of future damage for the clients increases.

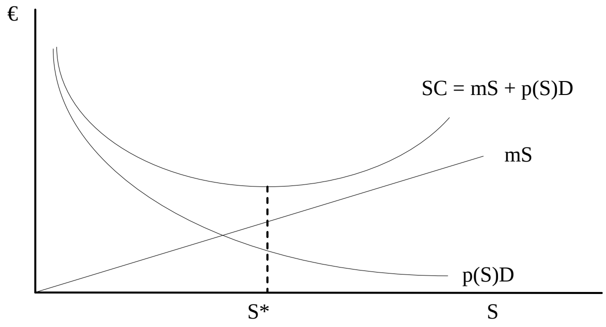


**Figure 3: A basic economic model of financial supervisory liability.**

In Figure 3, the expected social costs of accidents are obtained by adding up the line mS and the curve p(S)D. The result is the U-shaped curve, which I labelled SC = mS + p(S)D. The minimum of SC, corresponding with the value of S*, represents the level of careful supervision that minimizes the social costs. In other words, S* can be seen as the socially efficient level of careful financial supervision, where the marginal costs of taking care equal the marginal benefits of taking care; or, put differently, where marginal costs of care equal marginal benefits of damage prevention. At this efficient level of care, the total costs for society – made up of costs of damage plus costs of care – are minimised. But how can this desired level be reached using liability rules?

### 3.2.5 Third party financial supervisory liability: incentives for careful supervision?

In general, we can choose between rules of no liability, strict liability and negligence-based liability to achieve the incentives needed to obtain the efficient level of supervision. These liability regimes have, in theory, different impacts on the behaviour of financial supervisory authorities. It is obvious that a rule of no liability (or immunity) gives no incentives to financial supervisory authorities to take efficient care.[66] In this situation, other mechanisms should provide the financial supervisory authorities with the necessary incentives. On the other hand, this rule gives consumers a stronger incentive to take more care in selecting their financial institution because there is no alternative manner to get compensation.

Now, one must consider the situation in which supervisory authorities face strict liability. Strict liability of financial supervisory authorities implies that whenever third parties face damage resulting from the unlawful behaviour of financial institutions, the financial supervisory authority must pay for these damages. Under this rule, the

[66] See for a more detailed explanation Cooter & Ulen (2008).

financial supervisory authority has an incentive to minimize the costs that he or she bears. Consequently, the supervisory authority chooses S to minimize mS + p(S)D. This minimum occurs at the level of supervision denoted as S*, where the financial supervisory authority's marginal cost of precaution equals the resulting reduction in the expected cost of harm. Thus, a rule of strict liability gives supervisory authorities an incentive for efficient supervision. But what about the incentives for the other parties involved? With a strict liability rule for financial supervisory authorities, the financial institution receives no incentives from tort law, most likely resulting in more risk taking behaviour.[67] Financial supervisory authorities should prevent such a situation from happening. Furthermore, under a strict liability rule, third parties do not receive incentives from tort law. This could result in more careless behaviour on the side of the consumer, especially when choosing a suitable financial institution. Thus, despite the fact that a rule of strict liability creates proper incentives for financial supervisory authorities, it should still not be utilized when we take the negative side-effects into consideration.

A negligence rule, on the other hand, can give all parties involved incentives for careful behaviour. Under a negligence rule, actors have to comply with a legal standard of care in order to avoid liability. The applicable standard of care for financial supervisory authorities is denoted as S˚. So, when financial supervisory authorities act beneath the level S˚, the reasonable care or due care, they are held liable, while a level equal to or above S˚ leads to no liability (see Figure 4). The basic model assumes that the requested level of care is set at a level of care that is equal to the socially optimal level (S˚ = S*). Furthermore, it is assumed that this level is ex ante precisely known by all parties involved.

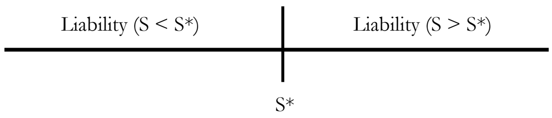


**Figure 4: Liability and the duty of care.**

In theory, this leads to careful financial supervision. A financial supervisory authority will not choose a supervision level above the level of care S*. This is because any care in excess of the standard would be more costly without reducing the costs of compensation, since due care is enough to be non-liable. In addition, he would not choose a level below due care, because then he runs the risk of bearing the total amount of expected damages. Thus, from the basic model of financial supervisory

[67] Under the assumption that the financial supervisory authority may not or is not able to recover (a part of) the damages from the financial institution.

liability, it becomes clear that under a negligence rule, financial supervisory authorities receive proper incentives in order to perform their supervisory tasks with adequate care.

*3.3 Preventing negligent financial supervision through liability rules?*

### 3.3.1 General

From the basic economic model of supervisory liability, it becomes clear that tort law, particularly a rule of negligence, can play an important role in generating incentives in order to achieve more careful financial supervision. So, it is obvious that a lot of lawyers use the deterrent effect of tort law as an argument in favour of (financial) supervisory liability.[68] But is this basic model accurate enough to predict the effect of liability on the behaviour of financial supervisory authorities? This part examines to what extent specific characteristics of the context in which financial supervisory authorities operate influence the deterrent impact of tort law and, as a consequence, the behaviour of the financial supervisory authorities. The context of the Dutch financial supervisory authorities is thereby used as a starting point. From various publications regarding Dutch financial supervisory authorities, I have come up with six specific characteristics which I will examine in detail (Tison, 2003; Giesen, 2006; Van Dam, 2006). These are: the behavioural model of financial supervisory authorities, the duty of care, damage, guarantee systems, safeguard clauses and insurance. Most of these characteristics also apply to other European financial supervisory authorities.

### 3.3.2 Behavioural model of financial supervisory authorities

We have seen that, from a law and economics point of view, tort law gives, in theory, a party an incentive to take an efficient level of care. To be able to do so, we obviously need a theory on behaviour. Without understanding and being able to predict the behaviour of an actor, it is impossible to know how to give them incentives in an effort to change their behaviour in a manner we would judge preferable. Thus, the prediction of the effect of a liability rule is very sensitive to assumptions about the underlying behavioural model (Spitzer, 1977). The basic economic model used the standard model of profit maximizing behaviour, which is commonly used in traditional law and economics analysis.[69] This model applies well to private companies. These companies are generally constrained to produce at minimum average cost in

[68] Nowadays, almost every lawyer is familiar with a basic knowledge of law and economics and, as a result, with the possible deterrent impact of tort law on the behaviour of various actors. As a consequence, lawyers often use these insights in their publications without a detailed understanding of the underlying mechanisms.

[69] The underlying model refers to the 'Homo Economicus'. People will act egoistically rational in that they will minimize the costs they are faced with in order to maximize their wealth.

order to maximize their profits. Faced with liability, they will take optimal care in order to avoid being held liable and experience a decrease in profits. But what about public authorities? Applying the profit maximizing model to a public authority seems to be more difficult. In general, public authorities do not pursue a goal of profit maximizing and, as a consequence, are not motivated by the desire to maximize profits (Kramer & Sykes, 1987; Rosenthal, 2006). Furthermore, the budget constraint of the State or public authority is not directly comparable to the ones of private companies or individuals (Roosebeke, 2006). When public authorities, for example, do not react to economic incentives at all, a 'no liability' rule or statutory immunities are optimal from a law and economics perspective (Cohen, 1990). Thus, we have to be careful in applying the standard model of profit maximizing behaviour to public authorities without a better understanding of the underlying behavioural model.

When we take a closer look at the behavioural models of public authorities, there are both maximizing ("rational-actor") and non-maximizing varieties (Spitzer, 1977). A maximizing model assumes that the governmental entity has a goal and is trying to do its best to achieve that goal, while this maximizing behaviour is not assumed in the non-maximizing model. The most important maximizing model of governmental behaviour was developed by Niskanen. He suggests that the goal of budget maximization will replace profit maximization in a bureaucracy, since many of the objectives of a bureaucrat (power, prestige, and salary) are directly tied to the size of the bureau that the bureaucrat oversees (Niskanen, 1971). But what about financial supervisory authorities? Financial supervisory authorities are public authorities and part of the governmental infrastructure of a country. It is obvious that they do not pursue a goal of profit maximizing, as their main goals consist of reducing financial market imperfections to establish confidence in financial markets. However, to fulfil these goals, financial supervisory authorities need some kind of budget that however can not be unlimited, considering the government has a lot of other goals to fulfil. Hence, financial supervisory authorities face, to a certain degree, a budget constraint, and shall try to maximize their budgets according to the theory of Niskanen. Furthermore, the behaviour of financial supervisory authorities is not only affected by budget maximizing behaviour, but also by minimizing political costs. Governmental liability, and thus financial supervisory liability, creates a political incentive to invest in adequate care to keep taxes low and avoid unnecessary government expenditures (Rosenthal, 2006). In response, I assume that the assumptions underlying the profit-maximizing model can also be applied to financial supervisory authorities. In other words, from an economic point of view, financial supervisory authorities shall try to maximize their budget and, therefore, try to prevent getting sued by third parties.[70] A

[70] An important assumption is that the potential impact of liability claims (in % of their total budget) is big enough to motivate them in taking adequate care. Cohen (1990) showed in his article that legal liability costs are often not a major concern to any particular department in determining its budgetary estimates. Actual legal exposure never exceeds 0.2% of a departmental budget.

way to accomplish that outcome is to take adequate care while performing their supervising tasks.

It is also important to notice that neither financial supervisory authorities nor financial institutions commit harmful acts – people do. Supervisory liability involves the imposition of liability on the organization itself due to the harmful act of the employees. But making the public organization liable, in this case the financial supervisory authorities, may fail to provide its employees with sufficient incentives to act carefully. This is because the sanction imposed on the organization might not reach the responsible individuals. Thus, the question arises, to what extent can the incentives (if any) be transferred from the organization to its employees? This chapter assumes that the organisation is capable of fully transferring the received incentives to the employees.

### 3.3.3 Duty of care

The basic model assumed that due care was set at the optimal level of care, and that there was no uncertainty regarding this level of care.[71] In the real world, however, legal standards are often uncertain. To determine the optimal level of due care, courts need complete and accurate information on the cost of care and the expected costs of accidents for each level of care. However, data necessary to set the optimal level of care will often not be available. Also, courts will not always be able to properly observe the actual level of care exercised by the injurer due to measurement errors, insufficient evidence and misrepresentation about the actual level of care. Thus, only during the trial, when parties present the facts of the case, is the due level of care established in a more precise way. Consequently, injurers exercising a certain level of care might not know ex ante whether they will be found negligent or not, either because they are not certain about the required level of due care or because they are not certain what level of care they will be found to have exercised (Kahan, 1989). Does this also apply to financial supervisory authorities? And what might that mean for the deterrent effect of tort law?

From jurisprudence and publications regarding the topic of supervisory liability, it becomes clear that the standard for financial supervisory authorities is 'reasonable care'.[72] But what is meant by reasonable care? The Supreme Court of the Netherlands pointed out in the Vie d'Or case that, in order to determine whether financial supervision complies with the standard of reasonable care, all circumstances of the individual case have to be taken into account.[73] These circumstances are the 'nature' of financial supervision; the fact that financial supervisory authorities have

[71] Uncertainty regarding the level of care can decrease over time due to the development of a lot of jurisprudence.
[72] See for instance sections 3.8 - 3.12 of the conclusion of A-G Timmerman with regards to the outcome of the Vie d'Or case (Supreme Court of the Netherlands, 13 October 2006, No. C04/279HR).
[73] See fn 72.

discretionary powers in order to fulfil their supervisory duties, and the fact that financial supervisory authorities face the difficult task of taking into account both the interests of the supervised institutions and the individual consumers (financial supervisor's dilemma). It becomes clear that the standard of reasonable care is surrounded by uncertainty for all parties involved. Therefore, it is likely that we can present the applicable standard of care for financial supervisory authorities as follows (see Figure 5).

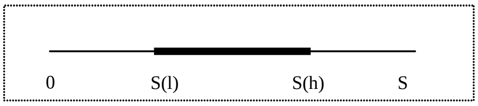


**Figure 5: Duty of care for financial supervisory authorities.**

In Figure 5, I have pointed out two levels of care, namely S(l) and S(h).[74] At the lower level of care, S(l), it is clear that below this level the financial supervisory authority was negligent and should therefore be held liable. There exists also a level of care, S(h), at which financial supervisory authorities know that they will not be held liable because they have taken enough care in exercising financial supervision. The optimal level of care lies, however, somewhere between these two levels.

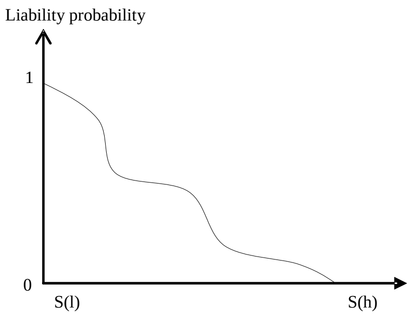


**Figure 6: Probability of financial supervisory liability.**

For every level of careful supervision between S(l) and S(h), there exists a certain probability that the financial supervisory authority is being held liable (Figure 6). However, this probability is ex ante unknown. From the above analysis, it becomes clear that the duty of care for financial supervisory authorities is vague and gives supervisors ex ante no exact guideline for performing their tasks. What does this mean from a law and economics perspective? Uncertainty regarding the level of due care

[74] This figure is derived from Schwarz (1998).

changes the deterrent impact of legal rules by creating two opposing effects (Craswell & Calfee, 1986).

The first effect is an incentive to over comply as a result of over-deterrence. In this situation, injurers will take more care than is prescribed by the legal standard of care. So, over compliance enables potential injurers to increase the chance that they will not be held liable. However, uncertainty also creates a positive chance that an injurer will not be held liable, thus reducing the incentives to comply with the legal standard (Schäfer & Schönenberger, 2000). The question thus created is which effect will prevail? In order to determine whether the net incentives are to under comply or to over comply, we need to know the relative strength of these two effects. However, this can not be determined ‘in general’ (Schwartz, 1998). An important factor to determine the net incentive in case of an uncertain legal standard is ‘damage’, which will be discussed in the next section.

### 3.3.4 Damage: Pure economic loss versus loss in confidence

Damage is an important condition for liability. Without it, there can be no liability. In general, we can identify two kinds of damages: pure economic or financial damage and immaterial damage. What kind of damage is most likely to occur when a financial institution goes bankrupt? When a financial institution goes bankrupt, clients will often lose (a part of) their money. Thus, the damage of an individual debtor exists primarily of pure economic loss. These kinds of losses are different from other losses, mainly because pure economic losses may, in fact, result in a transfer of wealth from one party to another, while ordinary losses result in the destruction of valuable resources. If a client of a financial institution loses money through the unlawful behaviour of this institution, it is likely that another party benefits from this behaviour. Let me use an example to clarify this: Suppose a financial institution undertakes a lot of risky investments and, as a result, does not comply with relevant prudential regulation, ultimately leading to its bankruptcy. The individual debtors lose all their money due to the unlawful behaviour of the financial institution. But, from society’s perspective, there might be no loss at all. Other financial institutions, as well as the issuers of the risky investments, might benefit from new customers. Overall, a transfer of wealth takes place between the parties involved in the default financial institution to other parties. For this reason, it is likely that the private loss to the victim is higher than the loss to society, which also takes the third party earnings into account.

So, what are the consequences from a law and economics perspective? To answer this question, we have to make a distinction between a precise level of care and the situation in which the due level of care is not precisely known ex ante. If the level of care is precise, overcompensation can not lead to over-deterrence because the potential injurer knows ex ante which level of care is necessary to avoid liability. He will choose this level of care in order to avoid compensation. One can only assume that overcompensation leads to a stronger incentive to take adequate care in this situation. It is unlikely however, that the potential injurer has an incentive to take more precaution at such a level. Therefore, overcompensation will not lead to over-deterrence when the level of care is precise. In this situation, there is no economic reason to refuse full compensation, including damages caused by pure financial losses (Mattiacci & Schäfer, 2007).

The picture changes drastically, however, if an uncertain legal standard is in place. This is the case for financial supervisory authorities, as explained in the previous section. A financial supervisory authority can not be guaranteed that he will avoid liability by taking a certain level of care while exercising supervision, as there is a residual probability that such level of care will be considered too low during the lawsuit. When we combine an uncertain legal standard with pure economic loss, the result may be over or under-deterrence. By taking more care, the injurer reduces the expected accident loss and the probability of being found negligent, but increases his costs of precaution. If damages are less than the social loss, under-deterrence will likely be the result, since the injurer does not face the total costs of his behaviour. On the other hand, if damages are in excess of social loss, the over-precaution outcome (over-deterrence) is more likely because there is an extra pay-off in decreasing the probability of being held liable. The problem of over-deterrence can be solved by negligence rules, which restrict compensation to cases of obvious negligence or to wilful behaviour. This makes the negligence standard more precise, thus avoiding over-deterrence.

Till now, I have assumed that the damage arising from bankruptcy of a financial institution only consisted of pure economic loss, namely the monetary loss for the depositor, and did not correspond with the social loss. However, the current financial crisis shows us that a social loss, which likely exceeds the pure economic loss, can occur. This loss is mainly caused by a lack of faith in the financial markets. It is difficult to quantify the loss in confidence, but the economic consequences can be very large. When a bankruptcy of a financial institution occurs, not only the depositors of this institution can lose confidence in the financial markets, but other participants as well. This can eventually lead to the collapse of other financial institutions, as the current financial crisis has demonstrated. When compensation is only based on the economic loss of the individual depositors of the collapsed institution, financial supervisory authorities do not internalize the total costs of their behaviour. As a consequence, under-deterrence is more likely to happen when the social loss is larger.

### 3.3.5 Guarantee systems

Another assumption underlying the basic model is that tort law is the only mechanism capable of getting compensation for losses suffered through the bankruptcy of a financial institution. From a law and economics perspective, it is important that the potential injurer internalizes all costs of his behaviour. Otherwise, he or she will receive an incentive from tort law that is less than the optimal situation and, as a consequence, will engage in more careless behaviour. The same goes for financial supervisory authorities. To be effective as a deterrence mechanism, financial supervisory authorities should face all costs of their behaviour. So is tort law the only mechanism to receive compensation from?

In the case of a bankruptcy of a financial institution, the answer to this question is negative. Most developed countries have depositor's protection schemes. For example, the European Council Directive 94/19 EC of May 1994 requires each member state to implement a deposit guarantee system with a minimum compensation of € 20,000. The primary object of any deposit guarantee scheme is to provide protection allowing depositors to be quickly repaid should a financial institution fail. If depositors have an accurate and clear understanding of the protection offered, then panic behaviour, like financial institution runs, can be avoided. In that way, deposit guarantee systems contribute to the financial stability of a country. However, the current financial crisis showed us that, despite the existence of such a deposit guarantee system, depositors panicked and withdrew their money from financial institutions in trouble. This behaviour, for example, led to the nationalization of Northern Rock in 2007 and Fortis in 2008. As a consequence, in October 2008, the Council of the European Union agreed, that it is a priority to restore confidence and proper functioning of the financial sector. This had led to a new proposal, in addition to the existing Directive 94/19 EC of May 1994, in which all member states provide deposit guarantee protection for individuals of at least € 50,000 for at least one year, compared with the former figure of € 20,000.[75] However, a number of member states have gone further and (temporarily) guaranteed even larger amounts.[76] For example, in the Netherlands, the guaranteed amount rose from € 40,000 to € 100,000. In the same period, the German government offered an unlimited guarantee for all private financial institution deposits. Ireland even offered an unlimited guarantee for all deposits.

But what is the influence of such guarantee systems on the deterrent effect of tort law? The basic model assumed that tort law was the only mechanism that could provide compensation. The threat of being held liable, and thus having to pay full compensation, gave financial supervisory authorities the necessary incentives to behave according to the optimal level of due care. When alternative means of

[75] See 2008/0199 (COD) Proposal for a Directive of the European Parliament and of the Council amending Directive 94/19/EC on Deposit Guarantee Schemes as regards the coverage level and the payout delay.
[76] On 7 October 2008, the Dutch minister of Finance announced the new guarantee limits. See also the memorandum of the Dutch Ministry of Finance (FM/2008-2610M) in which the current deposit guarantee limits of the EU are expressed.

compensation are available, it is obvious that the liability threat for financial supervisory authorities decreases. Depending on the amount of losses arising from the bankruptcy of a financial institution, people faced with these losses will always get full or partial compensation by the deposit guarantee scheme. Only if their losses are (much?) greater than the compensation from the deposit guarantee scheme, they have an incentive for holding the financial supervisory authority liable. Thus, the larger the amount of money a system guarantees, the less chance financial supervisory authorities face being held liable. The current average deposit of an EU citizen amounts to approximately € 30,000. With the new EU minimum deposit guarantee of € 50,000, 80%, as opposed to 65%, of deposits would be covered (with regards to the € 20,000 guarantee.[77] Thus, it is likely that an increase of the deposit guarantee amount will lead to a smaller chance that depositors are going to sue financial supervisory authorities.

From this analysis, we can conclude that the existence of depositor guarantee schemes eliminate some of the legal threat. As a consequence, financial supervisory authorities will receive fewer incentives from liability rules, more likely resulting in under-deterrence (leading to inadequate levels of financial supervision). It is important to notice that this suggested impact on the behaviour of financial supervisory authorities only occurs in cases of bankruptcy of financial institutions, which are under the supervision of a financial supervisory authority. Damage resulting from the unlawful behaviour of financial institutions that do not lead to their bankruptcy can only be compensated through the use of tort law. However, in the latter case, it is more likely that victims will sue the financial institution rather than try to get compensation from the financial supervisory authority by using tort law, mainly due to the fact that the latter procedure is much more difficult and uncertain.

### 3.3.6 Safeguard clauses and insurances

In the Netherlands, there are so called safeguard clauses between the financial supervisory authorities and the Ministry of Finance.[78] Through the existence of these safeguard clauses, the financial supervisory authorities face only a financial risk of 10% of their budget. The remainder of the damage is being compensated by the Dutch State. Like the existence of deposit guarantee schemes, this arrangement has a negative effect on the deterrent effect of tort law. With this kind of arrangements, financial supervisory authorities do not take into account the full costs of their activities, likely leading to under-deterrence with the possible consequence of less careful financial supervision.

[77] See fn 75.

[78] See Dutch Parliament (2005-2006), publication 30 300 IXB, no. 2, p. 23 and Dutch Parliament (1995-1996), publication 24 843, no. 1 p. 12. See also the memorandum of the Dutch Ministry of Finance of 17 November 2006 (FM 2006 01624M).

Besides safeguard clauses, financial supervisory authorities can also insure (part of) their liability risk. In the Netherlands, one of the financial supervisory authorities insured the risk of being held liable. To what extent does this influence the deterrent effect of tort law? From standard law and economics literature, it becomes clear that insurance has, in general, a negative impact on deterrence (Shavell, 1979). In other words, the insured party will display less care as a consequence of the insurance coverage. With the insurance coverage, an insured party no longer faces the financial consequences of taking less care. This behaviour is called moral hazard.[79] There are two partial solutions to the problem of moral hazard, namely incomplete coverage against loss and observation of the care taken to prevent loss. In case of incomplete coverage, a party is still exposed to some financial risk and will, therefore, be motivated to prevent loss. Observation allows the insurer to link the perceived level of care to either the insurance premium or the amount of coverage paid in the event of a claim. This gives the insured party an incentive to take care to avoid rising insurance premiums or partial coverage of the damage. In case of the Dutch Financial Market Authority (AFM), it is unknown whether, and if, the insurance company has defined specific conditions or terms for the insurance coverage.[80] However, it is likely that certain conditions do exist. With regards to the safeguard clauses, the Dutch State will not compensate the financial supervisory authority's damage in case of gross negligence or bad faith, or when the financial supervisory authority does not comply with certain other terms.

In order to give financial supervisory authorities sufficient incentives to perform the supervisory tasks assigned to them with adequate care, it is necessary that both the Dutch State and the insurance company can observe the level of care taken by the financial supervisory authorities. Due to the fact that the Dutch financial supervisory authorities operate independent from the State, it is difficult for the State to observe ex post the actual level of care taken by the supervisory authorities. Furthermore, we have seen that the requested duty of care, 'reasonable care', is vague. As a consequence, both the Dutch State and the insurance company will also have problems in determining whether the actual level of care corresponds with the reasonable care standard. This leads to the conclusion that safeguard clauses and insurance will likely lead to under-deterrence and, therefore, to less careful financial supervision.

[79] Moral hazard refers to the tendency of insurance protection to alter an individual's motive to prevent loss (Shavell, 1979).

[80] The AFM refused to make the content of their insurance policy public.

### *3.4 Conclusion*

The central question of this chapter is whether tort law will lead to careful financial supervision or to defensive conduct. Both statements are currently being used in EU member states, either in favour of or against the liability of financial supervisory authorities. This chapter used the insights from law and economics literature to analyze third party liability of financial supervisory authorities in the case of a bankruptcy of a financial institution. From the basic economic model of third party financial supervisory liability, it becomes clear that tort law can play an important role in preventing careless financial supervision. In order to maximize their budget and also to minimize political costs, financial supervisory authorities receive incentives from tort law to take optimal care in performing their supervisory tasks. However, the specific characteristics of the context in which the Dutch financial supervisory authorities operate, increase doubt in the certainty of this effect. Section 3.3 analyzed the impact of these characteristics on the deterrent effect of tort law. Table 5 shows a comprehensive overview of these impacts.

**Table 5: Overview of the impact of the characteristics of Dutch financial supervisory authorities.**

| Impact of characteristic | Under-deterrence | Neutral | Over-deterrence |
|---|---|---|---|
| *Vague duty of care & pure economic loss* | | | X |
| *Vague duty of care & loss in confidence* | X | | |
| *Deposit guarantee system* | X | | |
| *Safeguard clauses & insurance* | X | | |

From Table 5, it becomes clear that third party liability will most likely lead to under-deterrence, as the majority of the characteristics show us. This means that the current tort law regime does not give the Dutch financial supervisory authorities adequate incentives to perform the supervising tasks assigned to them with adequate care. Even in the situation where the bankruptcy of a financial institution does not lead to a social loss of confidence, under-deterrence is most likely to occur. Why? In order to work properly, the threat of being held liable must be severe enough to give financial supervisory authorities enough incentives to change their behaviour in way we judge preferable. The main threat of being held liable arises from the compensation a financial supervisory authority has to pay if he was found negligent. Due to the existence of a deposit guarantee system, safeguard clauses and insurance, Dutch financial supervisory authorities do not fully face the financial consequences of their behaviour and, as a consequence, will probably not take optimal care. On the other hand, under-deterrence also means that it is unlikely that liability will lead to defensive conduct.[81]

### *3.5 Commentary*

As this chapter was originally published in 2009, it does not take into account the change of legislation that took place in the Netherlands as of 1 July 2012. As of that date, the liability of the Dutch financial supervisory authorities was limited to cases of gross negligence and/or bad faith.[82] What does this change in legislation mean for the findings and overall conclusion of this chapter?

In Chapter 3 we have seen that the required level of due care under a negligence rule is reasonable care. The standard of reasonable care is, however, surrounded by uncertainty for all parties involved. To what extent is a standard of gross negligence a more precise standard? Gross negligence refers to actions that have fallen so far below the ordinary standard of expected care that the label 'gross' is warranted. It relates to conduct or a failure to act that demonstrates a substantial lack of concern for whether damage will result. It is likely that a standard of gross negligence makes it easier for the tortfeasor to avoid liability. Compared to simple negligence, a standard of gross negligence can therefore be considered more precise.[83] What does this mean for the deterrent impact of financial supervisory liability?

Section 3.3.4 showed that the damage resulting from the bankruptcy of a financial institution could be defined as pure economic loss. Compensating pure economic loss leads to over-compensation if this kind of loss exceeds the overall damage for society (Schäfer, 2004). If the level of care is more precise, overcompensation is, however, less likely to result in over-deterrence. A standard of gross negligence makes it easier for financial supervisory authorities to avoid liability and hence reduces their incentives to take precautions beyond the socially optimal level (Dari-Mattiacci & Schäfer, 2007). The change from a negligence regime to a gross negligence regime can therefore limit the unintended consequence of over-deterrence.

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[81] In a previous published paper, Dijkstra & Visscher (2007) concluded that a negligence rule is likely to result in over-deterrence. They therefore suggested to introduce a standard of gross negligence which could prevent over-deterrence from happening. However, the paper from 2007 did not take into account the existence of a deposit guarantee system. A deposit guarantee system, as we have seen in this chapter, eliminates a substantial part of the legal threat. As a consequence, financial supervisory authorities will receive fewer incentives from liability rules, more likely resulting in under-deterrence (leading to inadequate levels of financial supervision).

[82] See article 1:25d of the Dutch Act on financial supervision.

[83] However, it is important to note that it is not likely that a standard of gross negligence will reduce all uncertainty. Gross negligence needs to be established on a contextual basis, depending on the facts of each particular case. Even if a standard of gross negligence would result in the same amount of uncertainty as a standard of ordinary negligence, the overall conclusion of this chapter would not change, given the impact of the other characteristics.

So, the more precise the standard of due care, the less likely it is that over-deterrence will occur. The overall impact is shown in Table 6. This table compares the standard of gross negligence with simple negligence.

**Table 6: Comparing gross negligence with simple negligence**

| Characteristic | Simple negligence | | | Gross Negligence | | |
|---|---|---|---|---|---|---|
| | *Under-deterrence* | *Neutral* | *Over-deterrence* | *Under-deterrence* | *Neutral* | *Over-deterrence* |
| (Vague) duty of care & pure economic loss | | | X | | X | |
| (Vague) duty of care & loss in confidence | X | | | X | | |
| Deposit guarantee system | X | | | X | | |
| Safeguard clauses & insurance | X | | | X | | |
| **Impact financial supervisory liability** | **X** | | | **X** | | |

Table 6 makes clear that in the event of pure economic loss, the impact shifts from over-deterrence to neutral when introducing a standard of gross negligence. The table furthermore shows that the introduction of a standard of gross negligence does not change the overall conclusion of Chapter 3. Under both standards, financial supervisory liability is likely to result in under-deterrence. This is caused mainly by the impact of the deposit guarantee system, safeguard clauses, and possibilities for insurance.

# 4 Accountability of financial supervisory authorities: An incentive approach

## *4.1 Introduction*

### 4.1.1 Causes of financial supervisory failure

One of the most important responsibilities of financial supervisory authorities is to ensure that financial institutions act in conformity with legal norms. This duty is not only done in order to maintain the stability of our financial system but also to maintain the safety and soundness of individual financial institutions and to protect consumers from the unlawful behaviour of financial institutions (Llewellyn, 1999). Since the world banks have sailed into a sea of troubles, the role of financial supervisory authorities is being heavily discussed. Many people blame financial supervisory authorities for their part in the credit crisis – an accusation which is not so surprising given the fact that these authorities were specifically created to ensure the stability of our financial system. Even financial supervisory authorities themselves acknowledge that in some cases they have failed to provide adequate financial supervision.[84] What are the reasons for this kind of failure by financial supervisory authorities? In general, one can cite the following reasons (Ward, 2002; Tabellini, 2008).

First of all, financial supervision may fail because financial supervisors lack enough information in order to act adequately.[85] Furthermore, they may have enough information but are not sufficiently skilled or are skilled but simply make mistakes. They may also have too little power (or too much) which could lead to supervisory failure. These explanations of why financial supervision may fail are quite plausible. But is it complete? For example, in light of the recent financial crisis a great deal of information was actually available in addition to growing signs of concerns (Tabellini, 2008). However, the information was not acted upon despite the fact that most financial supervisory authorities had power to do so. Why then, did they not take adequate measures?

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[84] After the events at Northern Rock it became clear that the UK financial watchdog, the Financial Services Authority (FSA), failed to regulate Northern Rock adequately. The FSA said there had been a 'lack of adequate oversight and review' by the authority of the troubled bank. See the internal audit report of the FSA in 2008 (http://www.fsa.gov.uk/pubs/other/nr_report.pdf). US regulators failed to realize the massive risk American International Group's credit default swaps posed and should have stepped in sooner to stop the insurers from originating the products, according to the head of the Office of Thrift Supervision (see http://www.cnbc.com/id/29528855). In September 2009 it became clear the Securities and Exchange Commission had failed in uncovering Madoff
(see http://www.sec.gov/news/studies/2009/oig-509.pdf).

[85] In this chapter, "financial supervisory authority" and "financial supervisor(s)" are used interchangeably as the 'behaviour' of a financial supervisory authority is caused by the behaviour of individual financial supervisors.

A potential answer to this question may be a lack of adequate incentives (Kane, 1989; Ward, 2002; Schüler, 2003; Tabellini, 2008). Financial supervisory authorities, like any other organizations, are managed by people who have personal preferences. Instead of serving the public good, the actions of supervisors may be driven primarily by political motivations or private career concerns or in an attempt to advance their own institutional self-interests (Ward, 2002; Schüler, 2003). Without adequate incentives in place, they will not necessarily act in the public interest which could eventually lead to supervisory failure.

### 4.1.2 Accountability as an incentive mechanism

To prevent financial supervisory failure, arrangements should be in place to ensure that financial supervisors pursue the public interest or, at least, discourage them from pursuing their self-interests. These arrangements can be best described as incentives. In economics and sociology, an incentive is any factor (financial or non-financial) that enables or motivates a particular course of action, or counts as a reason for preferring one choice to another. It is an expectation that encourages people, and thus, financial supervisors, to behave in a certain way (Sullivan & Sheffrin, 2003). A distinction can be made between internal and external incentives.

With internal incentives I mean the incentives embedded in the organisational structure of the financial supervisory authorities such as the salary level, the existing culture and the existence of a code of conduct (Quintyn & Taylor, 2002; Weder di Mauro, 2009).[86] However, in this chapter I will only focus on external incentives. This latter category relates to incentives that financial supervisors face from outside their organisational structure. The literature regarding financial supervisory authorities shows us the importance of accountability as an external mechanism that could influence the behaviour of financial supervisors (e.g. Ward, 2002; Hüpkes et al., 2005; Masciandaro & Quintyn, 2006; Bovens et al., 2008; Amtenbrink & Lastra, 2008).

From a law and economics perspective, accountability can, in theory, provide financial supervisors with incentives to perform their supervisory tasks with adequate care. How? Financial supervisors have to comply with a (legal) standard of care in order to avoid the possible sanctions arising from accountability. If financial supervisors act beneath the requested level of care, they will face the negative consequences from being held accountable. Assuming that they, to a certain degree, are willing to maximize their private wealth or the budget of their supervisory authorities, they have an incentive to comply with the requested standard of care (and thus behaving in the interest of society) in order to avoid any consequences that will have a negative

[86] It is likely that low wages will stimulate regulatory capture and thus lead to a situation in which financial supervisors do not pursue the public interest (Quintyn & Taylor, 2002; Weder di Mauro, 2009). However, as already stated, I do not examine the effects of salary level on the performance of financial supervisory authorities in this chapter.

financial impact. Despite the fact that accountability is recognized as an important pillar of the governance structure of financial supervisory authorities, less attention has been placed on the effectiveness of accountability as an incentive mechanism (Hüpkes et al., 2005; Masciandaro & Quintyn, 2006).

### 4.1.3 Research method

In this chapter, I examine to what extent the existing accountability arrangements give Dutch financial supervisory authorities sufficient incentives for performing their supervisory tasks with adequate care (Van Dam, 2006a; Pratt, 2009).[87] The starting point is the application of the well known principal-agent theory and public choice theory on financial supervisory authorities. With the use of these theories, I will identify the possible conflicts between society and the financial supervisory authorities that can lead to supervisory failure. From this perspective, society is considered as the principal and the financial supervisory authority, the agent. Then, I will examine, with the use of literature regarding financial supervisory authorities, which consequences may result from being held accountable. The next step is to examine, with the use of insights from law and economics theory, whether these consequences are effective incentives that stimulate financial supervisory authorities to pursue the public interest or discourage them from pursuing their self-interests. This line of thinking is illustrated in Figure 7.

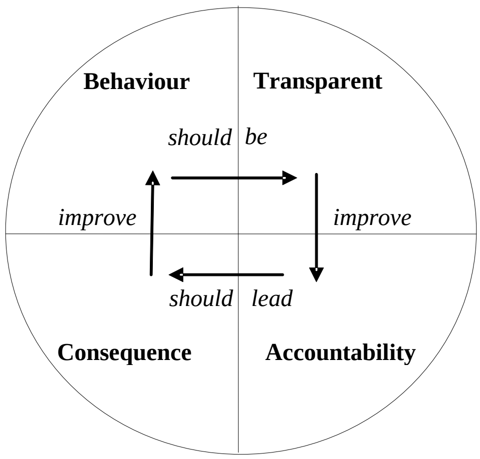


**Figure 7: Changing the behaviour of financial supervisory authorities.**

[87] The Dutch financial supervisory authorities are the Financial Market Authority (AFM) and the Dutch Central Bank (DNB). Due to the fact that financial supervisory authorities in other European countries have many characteristics in common, the outcome of this analysis may also apply to them.

In order to examine this, we also need a theory on behaviour (Dijkstra, 2009). Without understanding and being able to predict the behaviour of an actor, it is impossible to know whether certain consequences will change their behaviour in a manner we would judge preferable. Thus, the prediction of the effectiveness of accountability is very sensitive to assumptions about the underlying behavioural model. In this chapter I will use the standard model of profit maximizing behaviour, which is commonly used in traditional law and economics analysis.[88]

### 4.1.4 Outline

In addition to the introduction, this chapter is divided into four sections. The following section (4.2) applies the principal-agent theory and the public choice theory on financial supervision to explain the existence of conflicts of interest between society/government and the financial supervisory authorities. The next section (4.3) describes several consequences that financial supervisory authorities might face when they are being held accountable. I then examine, from a law and economics perspective, whether these consequences give financial supervisory authorities enough incentives to perform their supervisory tasks with adequate care (Section 4.4). The last section (4.5) contains a short summary and the conclusions of the chapter.

[88] The underlying model refers to the 'Homo Economicus'. People, and thus also authorities, will act egoistically rational in that they will minimize the costs they are faced with in order to maximize their wealth.

### 4.2.1 Introduction: principals and agents

It is important to understand why incentives are needed in the first place. A good manner for examining this is the application of the well known principal-agent theory to financial supervisors (Masciandaro & Quintyn, 2006).[89] In Figure 8, I have applied this theory and outlined the principal-agent relationships within the context of financial supervision.

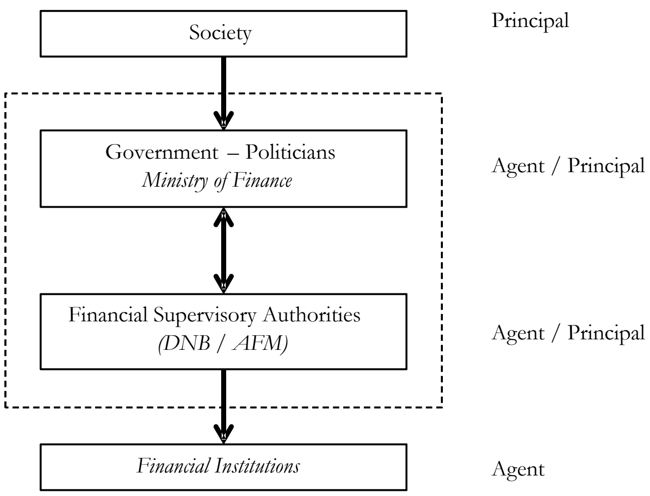


**Figure 8: Principal-agent relationships in the context of financial supervision.**

The starting point of principal-agent theory correspondents to the delegation of a task by the principal to an agent (Lavont & Martimort, 2002). In our case, society is the main principal. Individual members of society (citizens) formally have the task of supervising the financial institutions they do business with themselves. However, as we already have seen, they often lack the time, information and knowledge to monitor all the financial institutions properly. Given the importance of the financial sector for the welfare of society, this supervisory task is delegated to the government, or, for our purposes, the agent of society. However, the government often delegates the task of supervising financial institutions to a specialized authority. Why?

[89] However, it should be noted that some scholars do not agree with the assumption that the principal-agent theory is an adequate way to analyse the relationship between the supervisory authority and the government (Gilardi, 2008).

Financial supervision has characteristics that make delegation to bureaucrats attractive for politicians. First of all it is a highly complex activity which calls for the use of a specialized organization. Furthermore, due to its complexity, financial supervision has a high reputation risk – failure of financial institutions harms depositors and may therefore reduce re-election probabilities (Alesina & Tabellini, 2005; Masciandaro et al., 2007). So, therefore delegation to a specialized authority is attractive, both for society and government. The financial supervisory authority then acts as both the agent of the government and society. From Figure 8 it becomes clear that there exist at least three layers of agency problems: between society and government, between government and the financial supervisory authorities and between society and the supervisory authorities.[90] The latter two agency problems will be described in more detail in the next section.

### 4.2.2 The agency problem

Delegating a task to the government, who, in turn, delegates it to a specialized authority, results in information asymmetry within the various principal-agent relationships. Both society and the government have incomplete information about the actions of their financial supervisory authorities. Due to the fact that financial supervisory authorities are independent organisations, it is difficult for these actors to monitor the actions of these authorities adequately (mainly caused by a lack of time, information and knowledge). As a consequence, financial supervisory authorities can use their knowledge to deceive their principals about their behaviour. The agent is selected for his specialized knowledge, while the principal is never completely able to check the agent's performance. Furthermore, financial supervisory authorities are supposed to comply with their duty of confidence.[91] This means that they can not disclose all information obtained from their supervisory activities to the general public. In this way, the duty of confidence contributes to the information asymmetry between society and financial supervisory authorities. But to what degree is information asymmetry a problem?

Well, due to the existence of information asymmetry it is possible for the agent to pursue interests that deviate from the interests of the principal. In this way, a conflict of interests may occur. A principal-agent problem generally arises because agents not only have goals that conflict with those of the principals, but also have the discretion to pursue these goals because principals can not monitor all agent activity. This can result in severe problems. Thus the question remains, are there any conflicting interests between society, government and financial supervisory authorities? To find out, I will use insights from public choice theory.

[90] Besides the mentioned layers of agency problems, it is also likely that there exists an agency problem within the government and financial supervisory authorities. However, these 'internal' agency problems are no subject of research in this chapter.

[91] See for instance Section 1:89 and further of the Dutch Act on Financial Supervision.

### 4.2.3 Conflicting interests? A public choice perspective

To identify conflicting interests we must compare the interests of society, the government and financial supervisory authorities. The interests of society can generally be described by a stable financial sector; in other words, citizens have an interest in the soundness of individual financial institutions and the financial system as a whole (Schüler, 2003; Tison, 2005). What about the interests of the government and the financial supervisory authorities? Both are part of the so called public sector of a country. The traditional view identifies the public sector with the pursuit of the public good. However, do politicians and bureaucrats pursue only the public interest? Public choice theorists say no. Public choice theory applies the theories and methods of economics to the analysis of the public sector. It attempts to look at the government from the perspective of the bureaucrats and politicians who compose them, and makes the assumption that they act in a self interested way for the purpose of maximizing their own economic benefits.[92] So, instead of working in the public interest they are motivated by factors such as salary, public reputation and power (Tullock et al., 2002; Ward, 2002; Masciandaro et al., 2007). Therefore, public choice theory attributes deficiencies in the public sector to the existence of the private objectives of politicians and bureaucrats. What does this mean for our financial supervisory authorities?

If we take a look at the official goals of the Dutch financial supervisory authorities, one may notice that these goals correspond or contribute to the interests of society, namely a stable financial system.[93] The same goes for the Financial Service Authority (FSA) in the United Kingdom. The FSA focuses on the objectives of market confidence, public awareness, protection of consumers and reduction of financial crime (Singh, 2008). All contributing to financial stability. However, to what extent do supervisory authorities really pursue the interests of society? According to public choice theory, bureaucrats of financial supervisory authorities will not automatically pursue the public interest, that is to ensure the stability of the financial system by performing adequate financial supervision. Instead they may pursue their self-interest (Boot & Thakor, 1993; Schüler, 2003; Masciandaro & Quintyn, 2006).

Financial supervisory authorities, like any other organization, are managed by people who have personal preferences. Instead of serving the public good, the actions of financial supervisors may be driven primarily by political motivations, their reputation or private career concerns. In addition, they may try to advance their own institutional self-interests by seeking an increase in the power, reputation, prestige or size of their authorities. This self-interesting behaviour can lead to suboptimal financial supervision and ultimately supervisory failure. For example, the supervised financial

[92] See http://en.wikipedia.org/wiki/Public_choice_theory.

[93] See for the objectives of the Dutch financial supervisory authorities their website: www.afm.nl or www.dnb.nl.

industry may be an important source of future employment opportunities for the supervisory authorities' staff. Their obvious career path is to move to the regulated private sector where it is possible to claim lucrative appointments.[94] To accomplish such a self serving goal, financial supervisors might promote financial industry interests over those of the public. This is called regulatory capture, a term used to refer to situations in which a supervisory authority created to act in the public interest instead acts in favour of the commercial or special interests that dominate in the industry or sector it is charged with regulating or supervising.

Financial supervisors may also want to protect their careers or reputation by acceding to pressures from the people who strongly influence their careers – the politicians (Mishkin, 1996; Masciandaro et al., 2007). In this case, they might promote the interests of politicians, which may deviate from those of the public. This situation might result in regulatory forbearance (bureaucratic self capture), that is, allowing financial institutions to keep on operating as usual despite noncompliance with regulations because it is hoped that the problem will go away with time (Weder di Mauro, 2009). For example, the government may put pressure on the supervisor not to close a bank, as bank closure comes at a political cost, with depositors and possibly taxpayers being harmed. From the perspective above, financial supervisory failure can be seen as the result of a conflict between the public's interest and the private interests of financial supervisors enabled by information asymmetry.

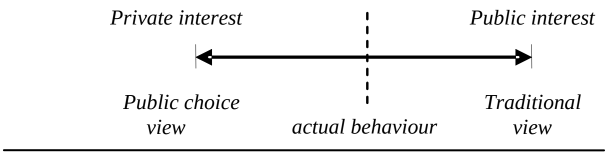


**Figure 9: Views on the behaviour of financial supervisors.**

It is fair to say that both the traditional view (public interest perspective) and the public choice view (private interest perspective) are the most extreme views of the public sector. So, the truth with regard to the behaviour of financial supervisors will lie somewhere in-between (see Figure 9). Such a statement insinuates, also from a more traditional view, that financial supervisors will still try to pursue their self-interest to a certain extent, thus leading to the existence of conflicts of interests between them and society.

[94] This kind of behaviour is consistent with the "career concern model" as presented by Alesina and Tabellini (2008b).

### 4.2.4 Conclusion

Financial supervisory failure may arise from the existence of conflict of interests between society and financial supervisory authorities. To ensure financial supervisors only pursuing the interest of society (resulting in adequate financial supervision) and thus discouraging them from pursuing their self-interest, it is necessary to have adequate incentives in place. How is this done with regards to the Dutch financial supervisory authorities?

## *4.3 Accountability as an incentive mechanism*

### 4.3.1 Introduction

The previous section concluded that incentives are necessary. Incentives, that stimulate financial supervisors to pursue the public interest and discourage them from pursuing their self-interest, need to be in place. But what do I actually mean by incentives? In general, an incentive is any factor (financial or non-financial) that enables or motivates a particular course of action, or counts as a reason for preferring one choice to another. It is an expectation that encourages people, and thus, financial supervisors, to behave in a certain way (Sullivan & Sheffrin, 2003). After examining the existent literature regarding financial supervisory authorities, it is clear that accountability is considered an important mechanism to discourage financial supervisors in pursuing their private interest (e.g. Ward, 2002; Hüpkes et al., 2005; Bovens et al., 2008; Amtenbrink & Lastra, 2008). In the following sections, I will discuss this topic in more detail.

### 4.3.2 Accountability: a way to limit the principal-agent problem?

Accountability is considered an important element of the governance structure of financial supervisory authorities (e.g. Litan et al., 2002; Hüpkes et al., 2005; Singh, 2007; Seelig & Novoa, 2009). As stated in Section 4.1.2, the threat of being held accountable gives financial supervisors, in theory, incentives to pursue the public interest instead of their self-interest. But does accountability indeed give sufficient incentives to the financial supervisors to perform their supervisory tasks with adequate care? The latter topic will be discussed in more detail in the next section which evaluates the effectiveness of accountability as an incentive mechanism. First I will address the meaning of accountability.

Accountability can mean different things to many different people (Bovens et al., 2008). In general accountability can be defined as an obligation owed by one person to another according to which the former must give account of, explain and justify his actions or decisions against criteria of some kind, and take responsibility for any fault or damage (Amtenbrink & Lastra, 2008). Accountability can be thought of as fulfilling three main functions with regard to financial supervisory authorities (Hüpkes et al., 2005). First, it is important to provide a democratic means to monitor and control the conduct of financial supervisory authorities (the lawyer's perspective). Second, accountability should help prevent abuses of power and third it should enhance the effectiveness of financial supervisory authorities. In other words, it should improve supervisory authority performance (the economist's perspective). Considering the topic of this chapter, I will primarily focus on the latter function of accountability.

To be recognized as an incentive mechanism, the definition of accountability has to be extended with consequences (rewards or sanctions) following a fair review of the performance of the authority. From this perspective, the concept of accountability also stands for the existence of adverse consequences once certain conditions are fulfilled (Amtenbrink & Lastra, 2008). These consequences should provide the financial supervisory authorities with the necessary incentives to perform their tasks with adequate care. When accountability is merely or primarily about disclosing information without any consequences, it is likely that it will not work properly as a mechanism to alter the behaviour of financial supervisory authorities. However, the possibility of consequences in the event of errors and shortcomings should motivate them to perform their tasks in the interest of society. In the next section, I will outline the potential consequences for Dutch financial supervisory authorities arising from their accountability.

### 4.3.3 Consequences for financial supervisory authorities

As stated above and in the introduction of this chapter, the threat of facing consequences from being held accountable should give financial supervisors incentives to take adequate care in performing their supervisory tasks. The majority of these consequences can be found in the law. For the Dutch financial supervisory authorities, potential consequences (sanctions) might be:

*Suspension or dismissal*

Section 1:26 of the Dutch Act on Financial Supervision states that the Minister of Finance has the power to suspend or dismiss by Royal Decree the Chair and other members of the Management when they fail to meet the requirements for the exercise of their duties or if they have seriously failed to perform these duties properly. Despite a few incidents where Dutch financial supervisory authorities failed to meet their supervisory tasks over the past few years, nobody was forced to step down or simply dismissed. However, examples of dismissal can be found in an international context. In Ireland, Mr. Patrick Neary, former chief executive of the Irish Financial Services Regulatory Authority, was forced to resign in January 2009 following claims that staff at the Regulator's office knew, since January 2008, that the disgraced chairman of Anglo Irish Bank, Seán FitzPatrick, had been transferring loans of up to € 87 million off the bank's book to conceal them from shareholders.[95] In 2009, Sir James Crosby, deputy chairman of the Financial Services Authority, resigned following the submission of a written memo by HBOS whistleblower Paul Moore to a parliamentary committee, which was hearing evidence on the factors behind the British recession.[96] Moore said Crosby, who was chief executive of the HBOS banking group from 2001 to 2006, fired him after he warned that the bank was endangering financial stability by taking too many risks. In January 2009, the director of the Icelandic Financial Supervisory Authority, Jonas Fr. Jonsson, and the board of the institution also stepped down after the Icesave debacle.[97] From the examples above we can conclude that dismissal of financial supervisors often means that they resign themselves following heavy internal or external pressure.

*Overruling*
As asserted in section 1:43 of the Dutch Act on Financial Supervision, the Minister of Finance has the power to decide that he will exercise one or more parts of the supervisor's function, or to have them exercised by another supervisor, if the Minister believes that the supervisor has seriously failed to perform his function. Thus far, I have not come across an example of this consequence in The Netherlands nor in any other country.

*Parliamentary survey*
Article 70 of the Dutch Constitution provides the Dutch Parliament the right to perform surveys. This right has further been outlined in the Parliamentary Survey Law. If the Dutch Parliament wants to examine the role or performance of the financial supervisors in a particular case, they can call for a parliamentary survey. For example, after the collapse of the DSB-bank some members of Parliament advocated a parliamentary survey regarding the role of the Dutch Central Bank and the Financial Markets Authority. Because the Minister of Finance himself had announced an independent investigation regarding the role of the financial supervisors in the collapse of DSB, a majority of the members of the Dutch House of Representatives was, however, against such a survey.[98]

*Liability*
Another consequence that may arise from accountability is the obligation to pay compensation after being held liable for supervisory failure. In The Netherlands, contrary to several other European countries, it is possible to hold the financial

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[95] See the Irish Times of 9 January 2009 http://www.irishtimes.com/newspaper/breaking/2009/0109/breaking75.htm).
[96] See BBS NEWS of 11 February 2009 (http://news.bbc.co.uk/2/hi/business/7883409.stm).
[97] See IceNews of January 25 2009 (http://www.icenews.is/index.php/2009/01/25/icelands-minister-of-commerce-and-board-and-director-of-fsa-resign).
[98] See the letter of the Dutch Minister of Finance of 29 October 2009 (FM/2009/2545 M).

supervisory authority liable on the grounds of shortcomings in their supervisory role. This is based on article 6:162 of the Dutch civil code. Examples of tort cases against Dutch financial supervisory authorities include the Vie d'Or case in which the Dutch Central Bank was being held liable, and the Befra case, in which the Dutch Financial Market Authority was being held liable. However, in both cases, the liability of the supervisory authorities was not established by court, and as a result, they were not mandatory to pay any compensation. In an European context we have also witnessed a number of cases of supervisory liability (Tison, 2003). For example, in the United Kingdom, a number of depositors claimed in 1995 damages from the Bank of England based on inadequate financial supervision, following the collapse of the Bank of Credit and Commerce International (BCCI). After a reserve judgement from the High Court said the case was no longer in the best interest of creditors, the liquidators for BCCI dropped their case against the Bank of England. Furthermore, supervised financial institutions have the right to appeal against any action or measure taken by one of the Dutch financial supervisory authorities, or to hold them liable if they suffer any damage from these measures.

*Reputation damage*

Thus far, we have only encountered consequences that are embedded in law. However, these are not the only consequences financial supervisory authorities can face when being held accountable. An important consequence that can arise from being held accountable is reputation damage. This particular consequence can not be found in law. Reputation damage can relate to the supervisory authority itself or its individual members, who are most likely the members of the Board. How does one's reputation get damaged? Reputation damage of financial supervisory authorities can occur as a side effect of the earlier mentioned consequences. For example, the liability of a supervisory authority as a result of supervision shortcomings will not only lead to an obligation to pay compensation but also have a negative impact on the reputation of the authority.

The same goes for the dismissal or suspension of a board member. Overruling of the supervisory authority will also have a negative impact on the reputation of the supervisory authority once this measure gets public. Furthermore, the outcome of a parliamentary survey regarding the role of the nation's financial supervisors can also lead to severe reputation damage. Reputation damage, however, can also occur without the earlier mentioned consequences. This scenario is most likely after the collapse of a financial institution, which often leads to severe damages for society. After such an incident, society (and the media) will often question the role of financial supervisors in the collapse. For example, both the reputation of Mr. Nout Wellink, the chairman of the Dutch Central Bank (DNB), and the supervisory authority found themselves under pressure after the collapse of Icesave and DSB.[99] As a consequence, the Dutch House of Representatives has become hesitant over the reappointment of Mr. Nout Wellink.[100]

## *4.4 Accountability as an effective incentive mechanism*

### 4.4.1 Introduction

To evaluate the effectiveness of the consequences arising from being held accountable, we also need a theory on the behaviour of financial supervisors. Without understanding and being able to predict the behaviour of financial supervisors, it is hardly possible to know whether (the consequences from) accountability will change their behaviour in a manner we would judge preferable. Based on public choice theory it is clear that financial supervisory authorities do not automatically pursue the public interest, but will instead try to pursue their self-interest. This abstract view on supervisory behaviour is, not, however, sufficient enough to use for evaluating the effectiveness of accountability as an incentive mechanism. So, before examining the identified consequences of accountability, I will start by describing a behavioural model of financial supervisory authorities based on the (theoretical) insights from law and economics.

### 4.4.2 A theory on the behaviour of financial supervisory authorities

Traditional law and economics analysis uses a model of profit maximizing behaviour (Cooter & Ulen, 2007). This model applies well to private companies. These companies are generally constrained to produce at the minimum average cost in order to maximize their profits. What about public authorities such as financial supervisory authorities? Applying the profit maximizing model to a public authority seems to be more difficult. In general, public authorities do not pursue a goal of profit maximizing and, as a consequence, are not motivated by the desire to maximize profits. Furthermore, the budget constraint of the State or public authority is not directly comparable to that of private companies or individuals. When we take a closer look at the behavioural models of public authorities, we find both maximizing ("rational-actor") and non-maximizing varieties (Spitzer, 1977). A maximizing model assumes that the governmental entity has a goal and is trying to do its best to achieve that goal, while the non-maximizing model does not assume such behaviour.

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[99] See for instance the article '*Nout Wellink: There are enormous gaps in our financial supervisory system*' in Vrij Nederland, 13 March 2009 and the article '*Nout Wellink lost authority*' in Elsevier, 24 October 2009.

[100] See for instance the article 'Parliament against the reappointment of Nout Wellink in Elsevier, 31 July 2009.

The most important maximizing model of governmental behaviour was developed by Niskanen. He suggests that the goal of budget maximization will replace profit maximization in a bureaucracy, since many of the objectives of a bureaucrat (power, prestige, and salary) are directly tied to the size of the bureau that the bureaucrat oversees (Niskanen, 1971). What about financial supervisory authorities? Financial supervisory authorities are public authorities and part of a country's governmental infrastructure. It is obvious that they do not pursue a goal of profit maximizing, as their main goals consist of reducing financial market imperfections to maintain the stability of our financial system as we already have seen in Section 4.1. However, to fulfil these goals, financial supervisory authorities need some kind of budget that can not be unlimited, considering the government has many other goals to fulfil. Hence, financial supervisory authorities face, to a certain degree, a budget constraint, and shall try to maximize their budgets according to the theory of Niskanen (Dijkstra, 2009).

The notion that the behaviour of financial supervisors and/or supervisory authorities is only effected by the impact on their private wealth or budget is not likely to be the complete picture. In reality, agents may get utility from some aspects of the task itself or from the actions they take in this job (Dixit, 2002). These effects are more likely to arise in public sector authorities, such as financial supervisory authorities, than in private firms. An important reason why agents in a public sector authority get utility from working there or from their actions is that they share some idealistic or ethical purpose served by the authority (Dixit, 2002). If financial supervisors get utility from the mentioned aspects, then less incentives are needed to secure the same level of effort.

In this chapter, however, I assume that the behaviour of financial supervisors is based on the effects it has, on both their private wealth, and the budget of the supervisory authority.

### 4.4.3 Evaluating the incentives

In the following paragraphs I will evaluate each consequence on the impact it has on the private wealth of a financial supervisor or the budget of the supervisory authority. To work properly, the threat of these consequences must be severe enough to give financial supervisors effective incentives to change their behaviour in a way we judge preferable. I assume that threat consists of a combination of two components, namely (1) the likelihood that financial supervisory authorities will face one or more of the mentioned consequences and (2) the magnitude of the financial impact from these consequences. For each consequence I will therefore answer the following two questions. How likely is it that financial supervisory authorities will face the mentioned consequences? And, what is the magnitude of the financial impact of these consequences on the supervisor's private wealth and the authority's budget? Based on the answers to these questions, I will make a judgement with regards to the effectiveness of these consequences.

*Suspension or dismissal*
It is likely that dismissal has a direct influence on the wealth of an individual board member. Furthermore, dismissal or suspension also may influence his wealth in the long term, as it is likely to damage a board member's reputation. The dismissal of board members has however no influence on the future budget of the financial supervisory authority. To be an effective incentive, the threat of being dismissed has to be severe enough. When a board member fails to meet the requirements needed for the exercise of his duties, or he has seriously failed to perform them properly, the Minister of Finance has to dismiss him. However, when does a board member fail in his duties? This is often difficult to judge, especially since there exists no clear standard of care for financial supervisors, the fact that they operate independently from the Ministry of Finance and have discretionary power in performing their duties. As a consequence, the dismissal or suspension of a supervisory authority board member almost never occurs. For example, despite robust critique with regard to the role of the Dutch financial supervisory authorities, there were, until now, no personnel consequences. In other countries, only a couple of financial supervisors stepped down, or were forced to step down, often following severe media pressure as we have seen in part three of this chapter. The likelihood that financial supervisors face this consequence is therefore low. What about the financial impact?

Dismissal will probably have a (short-term) negative impact on the private wealth of the financial supervisors, because they will not receive salary from the supervisory authority anymore. On the other hand, it is likely that they will receive a redundancy payment when being forced to resign or when being dismissed. Furthermore, former board members of a supervisory authority will not have too much difficulty in finding another job. However, when their reputation has been damaged, it is likely that their career opportunities have become less, effecting their private wealth in the longer term. The magnitude of this impact is however uncertain and depends on a lot of variables. Overall, the financial impact of a dismissal or suspension seems to be relatively limited.

*Overruling*
The exercise of (some of) the functions of the authority by the Minister of Finance himself or by another supervisor, does not impact the budget of a supervisory authority that has seriously failed in performing its duties nor the private wealth of the responsible financial supervisors. However, when it becomes public that the Minister of Finance has overruled a supervisory authority due to its shortcomings or failure, consequences for the reputation of the authority will likely follow. The financial impact of reputation damage, on the other hand, is limited as we will see in the

paragraph that deals with reputation damage. Due to the fact that there exist no clear standard of care for financial supervisory authorities, it is, as we already have seen, difficult to say when a supervisory authority seriously fails in performing it duties. So the likelihood that a financial supervisory authority will face this consequence is low. This can also be seen in practice. Thus far, I have not come across an example of this consequence in The Netherlands nor in any other country.

*Parliamentary survey*

A parliamentary survey has no immediate impact on the private wealth of a financial supervisor nor on the budget of the supervisory authority. However, the outcome of the survey might have an effect on the reputation of individual supervisors and the authority. During a parliamentary survey, embarrassing facts regarding the role of supervisors can become public, thereby affecting their reputation. Thus, participating in a parliamentary survey may have a (limited) financial impact, by means of reputation damage, on the supervisor's private wealth or authority's budget. However, the probability that financial supervisory authorities have to participate in a parliamentary survey is relatively low, given the fact that in the past 100 years only 36 parliamentary surveys have been carried out in The Netherlands, of which only one dealt with financial supervision.[101] Despite the fact that this probability is low, the chance that financial supervisory authorities, especially after the collapse of a financial institution, are going to be subject of formal investigations is much higher. For example, after the collapse of the DSB-bank, the Dutch Minister of Finance announced an independent investigation regarding the role of the financial supervisory authorities. Overall, it is not likely that the threat of having to participate in a parliamentary survey gives sufficient incentives for financial supervisory authorities.

*Liability*

Tort law can, in theory, be an important incentive mechanism, as the threat of being held liable will give financial supervisor authorities an incentive to perform the tasks assigned to them with (greater) care. Why? Financial supervisory authorities will try to prevent liability (and in that way prevent compensation for the damage) to maximize their budget. However, if we take a look at the Dutch financial supervisory authorities, we find a few specific arrangements in place that change this theoretical outcome. The existence of a deposit guarantee system and safeguard clauses, as well as the possibility of insurance, leads to a situation in which the Dutch financial supervisory authorities do not face any significant financial consequences (Dijkstra, 2009). In the case of bankruptcy of a financial institution, the deposit guarantee system ensures the victims compensation up to € 100,000.[102] Since the average deposit account in the

101 See http://www.parlement.com/9291000/modulesf/gxiomu23.

102 In October 2008 the Dutch Minister of Finance decided to increase the amount from € 40,000 (with an own risk of 10% for the last € 20,000) to €100,000 for a period of one year. In October 2009 it became clear that the amount of € 100,000 will remain for the period until December 2010.

Netherlands amounts to € 9,357, it is likely that the majority of the victims will not hold the financial supervisory authority liable because they are fully compensated.[103] This reduces the threat of liability for financial supervisors significantly.

Furthermore, there are so-called safeguard clauses between the financial supervisory authorities and the Ministry of Finance. Through the existence of these safeguard clauses, the financial supervisory authorities face a financial risk of only 10% of their budget, when being held liable.[104] As a result, the financial supervisory authorities will not face the full consequences despite being held liable. Financial supervisory authorities also have the opportunity to insure their financial risk which limits the financial impact of being held liable even further.[105] Compared to the other consequences, the financial impact of liability on the authority's budget can be considered medium.

Next, there exists no clear standard of care. It is therefore very difficult to assess whether the actual level of care of the supervisory authority corresponds with the reasonable care standard. As a consequence, the likelihood, and thus the threat, of being held liable diminishes. This can also be seen in practice. Dutch financial supervisory authorities have, till now, never been convicted to pay compensation despite the fact that victims of bankrupted financial institutions have tried to hold them liable on grounds of supervisory failure in several cases. Overall, it is not likely that tort law will provide the Dutch financial supervisory authorities with sufficient incentives to pursue the public interest with adequate care instead of their self-interest (Dijkstra, 2009).

*Reputation Damage*

In the previous paragraphs, we have seen that most consequences also contribute to reputation damage of the financial supervisory authority or its individual members. The threat of reputation damage can be an important mechanism to alter behaviour. This is most common in the private sector, characterized by competition. The private sector is generally characterized by a profit maximizing model. A bad reputation will lead to a decline in sales resulting in lower profit as customers will move from the bad reputation company to a competitor. Both the likelihood of facing this consequence and the magnitude of its financial impact is high. It is therefore likely that the fear of reputation damage will give private companies strong incentives to take adequate care in performing their activities. What about financial supervisory authorities? Reputation damage is likely to occur as we can witness in practice. Fuelled by the media, the Dutch Financial Market Authority, the Dutch Central Bank and its chairman, Mr.

[103] See Statistics Netherlands: http://statline.cbs.nl/StatWeb/publication/?DM=SLNL&PA=70813ned&D1=12-15&D2=a&HDR=T&STB=G1&VW=T.
[104] See the letter of the Dutch Ministry of Finance FM 2006-01624M dated 17 November 2006.
[105] See Dutch Parliament 2005/2006, publication 29 708, no. 39, p. 12.

Nout Wellink, for example, came under pressure after incidents with regard to Icesave and the collapse of the DSB-bank. It is likely that reputation damage has consequences for the future career opportunities of individual financial supervisors. This may affect their private wealth in the longer term. The magnitude of this impact is however uncertain and depends on a lot of variables. The financial impact of reputation damage on the authority's budget is also difficult to assess. A bad reputation might have an impact on the future budget of the supervisory authority as government is not willing to spend money on governmental authorities that do a poor job. On the other hand, lowering the budget of a financial supervisory authority will result in less available resources for performing supervision, and thus increasing the probability of future financial crisis. To my opinion, government will not take such a risk. Therefore, I assume that the financial impact from reputation damage on the future budget of the supervisory authority is limited. Based on a high likelihood and a relatively low financial impact, the fear of reputation damage will give financial supervisory authorities some incentives to pursue the public interest. However, it is important to notice that the desire to maintain a favourable reputation can also result in taking decisions to keep interest groups quiet and mistakes out of the public eye (Leaver, 2009).

### *4.5 Summary and conclusions*

There are many causes for financial supervisory failure. The most common are, lack of knowledge, lack of skills, and, lack of information. However, these causes may not provide a complete picture. An important factor that could contribute to financial supervisory failure is a lack of incentives. Delegation of the supervisory task by society to the government, who in turn delegates this task to specialized authorities, leads to the classical principal-agent problem. Since the principals (in this case society and government) are not able to monitor the agent (the financial supervisory authority) adequately, the financial supervisor may pursue his self-interest instead of the public interest, ultimately resulting in supervisory failure. To overcome this problem, incentives should be in place to stimulate the financial supervisors to pursue the public interest or, at least, discourage them from pursuing their self-interest. From a law and economics perspective, accountability could give financial supervisors sufficient incentives for performing their supervisory role with adequate care. However, to what degree is this the case for the Dutch financial supervisory authorities? Based on my analysis in the previous part, the following overall picture can be made (Table 7):[106]

[106] The distinction between direct and indirect relates to the fact that it is likely that some consequences not only have a direct impact on the private wealth or budget, but also contribute to reputation damage.

**Table 7: Accountability as an effective incentive mechanism?**

| Consequence: | Impact on private wealth? | | Impact on authority's budget? | | Likelihood of facing consequence? | Magnitude of financial impact? | Effective incentive? |
|---|---|---|---|---|---|---|---|
| | *Direct* | *Indirect* | *Direct* | *Indirect* | | | |
| Dismissal and suspension | Yes | Yes | No | No | Low | Low | No |
| Overruling | No | No | No | Yes | Low | Low | No |
| Parliamentary survey | No | Yes | No | Yes | Medium | Low | No |
| Liability | n.a. | n.a. | Yes | Yes | Low | Medium | No |
| Reputation damage | Yes | Yes | Yes | n.a. | Low | Low | Medium |

From Table 7 it becomes clear that, despite the fact that most of the consequences may have a negative financial impact (direct or indirect by means of reputation damage) on the private wealth of a financial supervisor or the budget of the supervisory authority, the likelihood that these consequences occur in practice can be considered low (with an exception for reputation damage) even as the magnitude of their impact. Thus, the threat of facing consequences from being held accountable, is not severe enough to give the Dutch financial supervisory authorities sufficient incentives for performing their supervisory tasks with adequate care.

### *4.6 Commentary*

As this chapter was originally published in 2010 it does not take into account the change of legislation that took place in the Netherlands as per 1 July 2012. As of that date, the liability of the Dutch financial supervisory authorities was limited to cases of gross negligence and/or bad faith.[107] What does this change in legislation mean for the findings and conclusion of this chapter?

Chapter 4 concluded that tort law will not provide the Dutch financial supervisory authorities with sufficient incentives to pursue the public interest with adequate care. This was based on the fact that different characteristics, such as the existence of a deposit guarantee system, diminish the likelihood of being held liable. By introducing a standard of gross negligence, it becomes even more difficult to hold the Dutch financial supervisory authorities liable based on shortcomings in performing financial supervision. As a result, supervisory authorities will not receive sufficient incentives to pursue the public interest with adequate care. The introduction of a gross negligence regime will therefore not change the findings and conclusion of this chapter.

[107] See article 1:25d of the Dutch Act on financial supervision.

# 5 Compensating victims of bankrupted financial institutions: A law and economic analysis

## *5.1 Introduction*

The bankruptcy of financial institutions and the manner in which victims are being compensated is receiving a substantial amount of attention these days. When a financial institution goes bankrupt, one of the first questions that arises is how will victims of bankrupted financial institutions be compensated? Of course, the number of potential victims in the case of bankruptcy of a financial institution is huge. One can think of the shareholders as primary victims since they will often lose the money they have invested in a company; other victims are obviously creditors who may not be completely reimbursed by the proceeds of the bankruptcy proceedings. However, the type of victims we are interested in, as they constitute the majority of concern for policymakers, are the clients who simply have put their savings into a bank account, in other words depositors. So, what are the compensation mechanisms they can rely on if their financial institution goes bankrupt?

The core of the compensation system is formed through a deposit guarantee system. Such a mechanism, aiming at the protection (IADI, 2009; Groeneveld, 2009) of clients of financial institutions is certainly not limited to Europe. Almost all Western countries have such a guarantee system to maintain stability of the financial system by preventing bank runs. However, despite the existence of this system, depositors may face losses when their deposits exceed the guaranteed amount. In these cases, they will have to rely on other instruments to get compensation for these losses, whereby tort law can be considered the most important instrument. Since the primary tortfeasor, the bankrupted financial institution, will not offer significant compensation options, victims will try to hold the financial supervisory authority or even the government liable. Financial supervisory authorities and governments have, compared to bankrupted financial institutions, deep pockets. The current structure of this compensation system raises several interesting questions. First, how does it affect incentives for welfare improving behaviour by all stakeholders involved? Thus the question could be asked to what extent the compensation system affects the incentives of potential clients to choose their financial institution carefully; the question could equally be asked how the guarantee system is financed and how does this system subsequently affect the behaviour of financial institutions and their leading officials? The guarantee system may also affect incentives of supervisory authorities which merits equal attention. Finally, one might ask how the different compensation mechanisms influence each other with regard to their incentive generating capability.

Even though plenty of literature has addressed the deposit guarantee system and its impact on the behaviour of banks and depositors, none of these papers included its impact on financial supervisory authorities and the government, nor do these papers address other compensation mechanisms that might be used by victims of bankrupted financial institutions. This chapter aims to address these issues. In order to examine the effect of compensation mechanisms on the incentives for the various stakeholders, we will use the insights of law and economics, as this methodology allows us to carefully analyze how regulation will affect the incentives and behaviour of stakeholders involved, and what the effects will be on social welfare.

Since deposit guarantee systems exist in many jurisdictions and in different forms, we will address potential effects of such a deposit guarantee system in a rather abstract manner; however, we will also focus on the regulation of one particular legal regime to discuss and analyze how it works in a more detailed way. For that reason we have chosen the deposit guarantee system (in relation to other compensation mechanisms available) in the Netherlands. We examine to what extent the Dutch compensation structure provides sufficient incentives for all parties involved in case of bankruptcy of financial institutions. Hence, we examine the impact of the current compensation structure on the behaviour of depositors, financial institutions, financial supervisory authorities and government. The goal of this chapter is to provide an economic analysis, using the law and economics methodology, of the compensation system for victims of bankrupted financial institutions in the Netherlands. In addition, we expect that the analysis of one particular legal system will also allow a few general comments on the pros and cons of various compensation techniques, including a deposit guarantee system.

In addition to this introduction, this chapter is divided into five sections. The following section (5.2) describes the compensation structure that currently exists in the Netherlands in more detail. The next section (5.3) provides an economic analysis of this compensation structure. Using insights from law and economics we make predictions with regard to the incentive effects of this structure on all relevant parties, being the (actual and potential) depositors, the financial institutions, the financial supervisory authorities and the government. In Section 5.4 we introduce some adjustments to the current compensation system in the Netherlands. Section 5.5 contains the conclusions and recommendations of our research.

### *5.2 Compensation structure*

A client who has deposited his savings with a financial institution that subsequently goes into bankruptcy has a variety of ways to look for compensation of his losses. The core of the compensation structure in the case of bankruptcy of a financial institution is formed by the deposit guarantee system. This system provides (automatic) compensation for the amounts deposited by the client in the bank. Given the low threshold, this procedure is the easiest and most obvious way for the victim to obtain compensation of his losses. However, compensation through this system is restricted to a certain amount. When depositors lose more than this amount, they can try a number of other mechanisms to collect compensation for the remainder of their losses. The most important are submitting their claim to the liquidator and the use of tort law. In the following sections we describe this compensation structure in more detail.

### 5.2.1 Deposit guarantee system

The primary objective of any deposit guarantee scheme is to provide protection, thus allowing depositors to be quickly repaid should a financial institution fail. If depositors have an accurate and clear understanding of the protection offered, then panic behaviour, like bank runs, can be avoided. In that way, deposit guarantee systems contribute to the financial stability of a country (Campbell et al., 2007; Groeneveld, 2009). The bankruptcies of various financial institutions in the sixties and seventies resulted in most countries establishing explicit deposit guarantee systems. The international affair with regard to the Bank for Credit and Commerce International (BCCI) was the reason for developing European legislation. In 1994 the European Council published Directive 94/19 EC on deposit guarantee schemes, followed in 2009 by an addition, namely Directive 2009/14 of 11 March 2009. This new directive replaces some of the articles of the Directive from 1994. Having introduced the European regulatory framework of the deposit guarantee system, it is now time to discuss the Dutch deposit guarantee system.

After the bankruptcy of Teixeria de Mattos in 1966, the Dutch Central Bank together with the banks decided that small depositors should be protected from the bankruptcy of financial institutions. This resulted in a collective guarantee system that was embedded in the Act on the Supervision of the Credit System in 1978. Since that time, the Dutch Central Bank (DNB) has been responsible for operating the deposit guarantee system. After the collapse of Van der Hoop Bankiers in 2005, the Dutch government adjusted the existing regulation. The financial crisis of 2008 led to another adjustment of the existing deposit guarantee system. In the following paragraphs, we will describe the main elements of the deposit guarantee system. The starting point is formed by the contents of the EC Directives, followed by details of the Dutch system.

One of the most important elements of any deposit guarantee system is the minimum level of coverage it provides. Initially, the Directive of 1994 established a deposit guarantee protection for individuals of at least € 20,000. However, due to the financial crisis that started in 2008, the Council of the European Union agreed, that it was a priority to restore confidence and proper functioning of the financial sector. This decision led to the Directive 2009/14 which states that all member states should provide deposit guarantee protection for individuals of at least € 50,000 for at least one year, compared with the former figure of € 20,000. Furthermore, the Directive states in section 3 that by December 2010, coverage for the aggregate deposits of each depositor should be set at € 100,000. The possibility for Member States to limit coverage to a specified percentage should also be discontinued as stated in section 14 of Directive 2009/14. But, what about the Dutch deposit guarantee scheme?

Initially, the Dutch deposit guarantee scheme ensured an amount of € 20,000. In 2005 this amount was increased to € 40,000. Of this amount, € 20,000 was completely guaranteed, while depositors faced a risk of 10% on the next € 20,000. As a consequence, depositors could only receive a maximum compensation of € 38,000 if their deposits exceeded the amount of € 40,000. This kind of coverage is referred to as co-insurance. As a result of a legislative change (following the financial crisis) in October 2008 the guaranteed amount rose from 40,000 to € 100,000 without any co-insurance. This amount is over of the prescribed level of coverage (€ 50,000) by the European Commission for 2010, but in line with the years to follow.

Another element is the period in which the pay-out takes place. The former Directive provided a pay-out delay of three months which could be extended to nine months. However, this long period does not adequately contribute to depositor confidence. In the latest Directive, the pay-out delay was therefore reduced to a period of 20 working days. This period should only be extended under exceptional circumstances. Currently, the pay-out period in the Netherlands is set at a maximum of three months after receiving the claim from the depositor.

Until now, there exists no harmonized manner with regard to funding the deposit guarantee system. The European Directive 94/19 did not address the point of financing. The Directive of 2009 states that the European Commission should have submitted a report on the funding mechanisms of deposit guarantee systems to the European Parliament and Council by 31 December 2009. The outcome of this report could have led to appropriate amendments to the Directive of 2009 by the European Commission. Thus far, we have not encountered any amendments relating to the funding of the deposit guarantee system.

In general, a deposit guarantee system can be funded in three ways, namely ex ante and ex post, and a combination of ex ante and ex post mechanisms (IADI, 2009). Ex ante funding requires the accumulation and maintenance of a fund to cover deposit insurance claims and related expenses prior to a failure actually occurring. It is funded by its members through contributions, insurance premiums and other means. Ex post funding occurs after the bankruptcy of a financial institution. The costs for the claims arising from the deposit guarantee system are born by the surviving financial institutions. Research by the European Commission in 2007 shows that 16 Member States are using an ex ante funding system, while 6 Member States have adopted an ex post scheme. Five deposit guarantee systems do not meet the requirement to be classified as either ex ante or ex post. These schemes can be categorized under a mixed system (IADI, 2009).

The funding mechanism used in the Netherlands is regulated in article 3:259 section 4 of the Act on Financial Supervision. The Dutch system is based on ex post funding. Thus, only after the failure of a financial institution, do the surviving banks have to contribute. The level of contribution of each financial institution is based on their market share in the savings market. Article 3:261 section 3 of the Dutch Financial Supervision Act states the legal consequences of receiving compensation. By receiving compensation from the deposit guarantee system, the victim transfers his claim on the bankrupted financial institution to the Dutch Central Bank. In this way, the Dutch Central Bank might get compensation from the bankruptcy's proceedings.

Until now, we have talked about explicit deposit guarantee systems. These systems are formally embedded in law. However, some scholars assume that every country has also a de facto implicit deposit guarantee system in place because governments are pressured to provide assistance when a large systemic banking distress occurs (Demirgüç-Kunt et al., 2005). In the current financial crisis we have witnessed the bail out of several large financial institutions around the world by the government. Examples include Bear Stearns, Fanny Mae, Freddy Mac, Citygroup Inc. and Fortis. The bail out or nationalization of a distressed financial institution is not a mechanism on which depositors can rely. It is a mechanism which can only be applied by the government. Currently, there exists no specific law in the Netherlands which provides the government a legal foundation for a bail out of a financial institution. In the United Kingdom, Ireland, Austria and more recently Germany, these laws already exist. A bail out of a financial institution by the government means that a depositor will not face any losses. Simply put, a bail out frees a financial from bankruptcy, thus allowing it to meet its obligations. Bail outs, or nationalization of financial institutions, often relate to the phenomenon 'too big to fail'. This phrase refers to the idea that the largest and most interconnected businesses are so vital that a government can not allow them to declare bankruptcy because said failure would have a disastrous effect on the overall economy.[108]

### 5.2.2 Submit claim to liquidator

If a depositor would face losses in excess of the € 100,000, which is currently guaranteed through the deposit guarantee system in the Netherlands, he or she will not be compensated by the deposit guarantee system for the remainder. The most obvious way to receive compensation for these excess losses is to submit a claim to

[108] See Wikipedia (2010), '*Too big to fail*', Wikipedia, viewed 23 June 2010. http://en.wikipedia.org/wiki/Too_Big_to_Fail.

the liquidator. Such an action can be done according to section 110 of the Dutch Insolvency Act. In theory this submission can lead to compensation still being paid, but in practice ordinary creditors (which the depositor would in that case be) usually have little chance of fully recovering their losses. The reason is that there may be many so-called proprietary creditors, like mortgage holders, social security institutions, etc., as well as (often very important) the tax authorities. Only after those claims have been satisfied will compensation to ordinary creditors be paid. In reality, ordinary creditors often receive little or no compensation through the bankruptcy proceedings (Couwenberg & De Jong 2006, 2008). Compared to the deposit guarantee system, compensation from the bankruptcy proceedings will often take a long time; the bankruptcy of Van der Hoop Bankiers in 2005 is an example. The liquidators of this bankruptcy expected that the liquidation could be completed in 2010.

### 5.2.3 Tort law

Another way of trying to obtain compensation for the remaining losses is by holding one or more of the parties involved liable. A depositor can try to hold the bankrupted financial institution itself, its board members, the financial supervisory authorities or the government liable for their shortcomings. In reality, claims against the institution itself or the government are rare. Tort claims against (former) board members are theoretically possible, but the threshold for liability is relatively high. The mere fact that a financial institution goes bankrupt and can not meet its obligations does not necessarily imply that board members acted wrongfully. In addition, it is unlikely that board members have enough assets to pay for all the damages.

Therefore, a more likely candidate to sue (often discussed in legal doctrine, but increasingly also seen in practice) is the financial supervisory authority who failed to act appropriately to prevent the bankruptcy of the financial institution (Tison, 2005; Giessen, 2006). Liability of financial supervisory authorities is, however, a controversial topic in Europe. Some countries have statutory protections in place to protect their financial supervisory authorities from being sued, while other countries are submitting their financial supervisory authorities to normal liability rules (Dijkstra, 2009). In the Netherlands, there exist no specific rules on the legal basis on which these parties can be held liable, so the legal basis is founded by article 6:162 of the Dutch Civil Code. Examples of tort cases against Dutch financial supervisory authorities include the Vie d'Or case in which the DNB was held liable and the Befra case in which the AFM was held liable. However, in both cases, the liability was not established by court, and as a result, they were not obligated to pay any compensation.

Compared to the deposit guarantee scheme, compensation via tort law is not restricted to a certain amount. In other words, victims might be fully compensated. On the other hand, while compensation from the deposit guarantee system is guaranteed and takes place within a relatively short period after the bankruptcy, tort cases may leave a person waiting many years for an uncertain outcome.

### 5.2.4 Conclusion

In this section we have outlined the compensation structure that currently exists in the Netherlands when a financial institution goes bankrupt. It is relatively clear that the most attractive system from the victim's perspective is the deposit guarantee fund. First it provided a guarantee that savings up to € 40,000 would be paid back, and in 2008 this amount was even increased to € 100,000. Given the low threshold of recovery, this will be the primary tool used by victims. Next victims can choose to submit their claim to the liquidator. However, it is not likely that depositors will receive (full) compensation from the bankruptcy proceedings since they are only ordinary creditors. A third tool which may be used is tort law, in which the most likely defendant is the financial supervisory authority, held responsible for his failure to adequately supervise the financial institution in question.

**Table 8: Characteristics of the different compensation mechanisms.**

| Compensation mechanism: | Compensation level | Pay-out period | Success rate |
|---|---|---|---|
| Deposit guarantee fund | Limited to € 100,000 | < 3 months | 100% |
| Submitting claim to liquidator | Full | Often several years | < 100% |
| Tort law | Full | Often several years | < 100% |

## *5.3 An economic analysis of the compensation structure*

### 5.3.1 Introduction

We will now turn to the central question of this chapter: the economic effects of the various compensation mechanisms for victims of bankrupted financial institutions. We will mainly address the deposit guarantee system and tort law and analyze, with the use of insights from law and economics, how these instruments could affect stakeholder behaviour.

### 5.3.2 Explicit deposit guarantee systems

Despite the fact that a deposit guarantee system can contribute to financial stability by making bank runs less likely, it can also *ex ante* create adverse incentives for the parties involved. In general, the existence of a deposit guarantee system will lead to moral hazard as the various stakeholders are sheltered from the negative consequences of their behaviour (Shavell, 1979). Clearly, the more complete the deposit guarantee system, the more likely it is that moral hazard will occur (Schich, 2008). We will now more specifically analyze how such a deposit guarantee system could potentially affect incentives of the various stakeholders.

*Incentives of financial institutions*

The existence of a deposit guarantee system can give financial institutions an incentive to pursue more risky investments (Demirgüç-Kunt & Kane, 2002; Goodhart, 2009). This behaviour is called moral hazard. Moral hazard in banking arises when banks are provided with incentives to take risks and can retain the returns, while still passing the (potential or realized) costs of the risk to the depositors, financial supervisory authorities or taxpayers (Mullineux & Murinde, 2003; Groeneveld, 2009). In addition, risky financial institutions will often pay higher interest rates to attract funding. We have witnessed this with Icesave, which offered an interest rate of 5.25% compared with an interest rate of 3.4% offered by Rabobank during the same period. So it is likely that a deposit guarantee system encourages (excessive) risk-taking by insured institutions leading to a negative impact on their solvency (Santomero, 1997).

However, the way a deposit guarantee system is funded may, to some extent, counterbalance these adverse incentives. Ex ante funding with the use of risk-based premiums can give the participating financial institutions incentives to lower the risk of their operations in order to lower the premiums they have to pay for the deposit guarantee fund. Given that financial institutions are profit maximizing institutions, they will try to lower their premiums as much as possible in order to maximize their profits. In this way, a risk based premium will give financial institutions incentives to behave with less risk (Crocker & Snow, 2000; Groeneveld, 2009). Until now, only eight European countries apply a risk based contribution to their deposit guarantee fund. The differences ranged from a minimum contribution of 75% to a maximum of 140% of the standard amount (European Commission, 2008). One might question whether these differences will give financial institutions sufficient incentives to lower the risk of their operations.

Looking at the funding of the Dutch deposit guarantee fund, one may notice that the contribution by financial institutions (1) is ex post and (2) depends on the size of their business and not on their risk exposure. Therefore, it is unlikely that the current deposit insurance system in the Netherlands gives sufficient incentives to the financial institutions for keeping their risk level average (Kam Hon Chu, 2003). This means that there has to be a strong supervisory system to handle these potentially adverse effects from the existing deposit guarantee fund.

*Incentives of potential depositors*

Another question is how a deposit guarantee system affects incentives of potential clients (depositors) wishing to bring their savings to a financial institution. A deposit guarantee system reduces the incentives for depositors to monitor the risks of the financial institutions they are doing or willing to do business with. The reason is that if depositors know *ex ante* that they are fully being compensated when a financial institution goes bankrupt, they have no incentive to look critically at the financial institutions they are willing to do business with. It is likely that they will care little about the assets their institutions hold or their likelihood of failure as their claim is on the government, not against the financial institution itself (Santomero, 1997). The power of this adverse incentive depends on (1) the level and (2) structure of deposit coverage. Within Europe, the level of deposit coverage varies amongst the member countries with a minimum level of € 50,000 as stated in a directive of the European Commission. Calculations of the European Commission show that 80% of savings is already covered at this level (Groeneveld, 2009).

Besides the level of deposit insurance, the structure of the coverage also impacts the incentives for depositors. Some countries implement a certain excess in their deposit coverage. For example, the first layer, for instance € 20,000, is guaranteed in full, while the next layer, say € 80,000, may only be guaranteed up to 50%. In this way depositors still face a certain financial risk; it should encourage them to monitor the financial institutions they are doing business more carefully. This mechanism is called co-insurance. However, as already mentioned, the European Commission has abandoned the use of co-insurance in their new directive (2009/14).

The deposit guarantee system in the Netherlands appears rather generous: after the implementation of Directive 94/19 the guaranteed amount was € 40,000 (with co-insurance of 10% over the last € 20,000), and in 2008 it was increased to € 100,000. Since full coverage is guaranteed to his amount, there is no risk sharing. Deposit holders, who only have an amount at stake of no more than € 100,000 are *ex ante* sure of being fully compensated, and can, in theory, go for the financial institution that offers the highest profits (in interest rates) without having to worry about the solvency of the institution where they bring their savings.

It is important to note that the previously described group of depositors is not the only category of stakeholders of a financial institution. Uninsured depositors like other creditors and shareholders, are still exposed to risks from the financial institution. This should encourage them to monitor and limit the riskiness of the bank (Groeneveld, 2009). A question one might ask is which party is in the best position to monitor financial institutions? In this chapter we assume that all parties are equally important for monitoring financial institutions.

*Incentives of financial supervisory authorities*

Knowing the existence of the deposit guarantee system and its effects on the insured institutions and depositors, financial supervisory authorities are forced to take on a more active role (Schich, 2008; Groeneveld, 2009). The question arises of to what extent this pressure is felt in practice by financial supervisory authorities. The existence of deposit insurance is likely to give financial supervisory authorities an adverse incentive. Why? In case of a bankruptcy of a financial institution, society will usually immediately look at the role of financial supervisory authorities. The question whether the financial supervisory authorities failed in their supervision of the bankrupted institution will be asked not only by the public at large, but also by victims of bankrupted financial institutions. If the answer to this question is positive, it is likely that victims will hold the financial supervisory authorities liable on the grounds of shortcomings in their supervisory role. In this way, the threat of tort law gives financial supervisory authorities an incentive to take adequate care in performing their supervisory role and ensuring that financial institutions comply with the legal rules. However, a deposit guarantee system mitigates this incentive. When a victim knows he is going to receive compensation from the deposit guarantee fund, it is very unlikely that he or she will try to hold one of the financial supervisory authorities liable. A depositor will only do this when the damage he faces is (much) larger than the amount he receives from the deposit guarantee fund. Thus, the higher the deposit guarantee fund provides coverage, the less likely it is that depositors will hold the financial supervisory authority liable. Since the average deposit account in the Netherlands amounts to € 9,357 and the deposit guarantee amounts to € 100,000, it is likely that the majority of the victims will not hold the financial supervisory authorities liable because they are fully compensated.[109] As a consequence, the incentive for financial supervisory authorities arising from tort law to keep a close watch on the behaviour of financial institutions will be smaller.

*Incentives of government*

The analysis of the influence of the deposit guarantee system on the incentives of government is very similar to that of the financial supervisory authorities. Indeed: in case of failure of a financial institution the government is at risk to be called upon by victims or could, assuming it had a role in the failure, could be held liable in tort law. Hence, the larger the monetary amounts provided under a deposit guarantee system, the less likely the government will be called upon in tort liability, or to provide another kind of *ex post* relief (Kaplow, 2000). In that sense, a deposit guarantee fund reduces incentives for government. However, by increasing the reimbursement level governments face a greater financial risk (Groeneveld, 2009). This is certainly the case in an ex post funding scheme, where the government will often make pay-outs itself and then collect the money from the surviving financial institutions (IADI, 2009). In

[109] See for the average deposit account Statistics Netherlands (2010), '*Savings as per 31 December, 2003 – 2008*', viewed on 23 July 2010
http://statline.cbs.nl/StatWeb/publication/?DM=SLNL&PA=70813ned&D1=12-15&D2=a&HDR=T&STB=G1&VW=T.

case of a financial crisis, the question remains to what extent the financial institutions are able to make their contributions. Government can come under pressure to provide financial assistance.

From a law and economics perspective, exposure to (a greater) financial risk gives governments incentives to take measures to prevent the failure of financial institutions. Governments, consisting of politicians, strive to be re-elected (Alesina & Tabellini, 2007). The failure of a financial institution will result in many costs that are ultimately going to be borne by the taxpayers or voters of a country. This may have a negative impact on the re-election chances of the current government. Hence, we expect that governments facing greater financial risk arising from the deposit guarantee schemes (e.g. larger guaranteed amounts) to take measures to prevent such an incident from occurring. These measures may consist of tighter financial regulation or delegating more power to the supervisory authorities. In this way, the reduced incentives from tort law are (partly) being compensated by incentives arising from facing (a greater) financial risk. This will only be the case, however, in a financial crisis.

### 5.3.3 Implicit deposit guarantee systems: bail out or nationalization

In recent years, we have witnessed the bail out of several financial institutions, not only in the United States but in Europe as well. As a result of the financial crisis the US government bailed out AIG, Bank of America and Citigroup, while in Europe Northern Rock, Fortis and Hypo Real Estate were, amongst others, bailed out by their governments. The bail out of these financial institutions can largely be related to the term 'too big to fail'.

The question arises what the effects may be of this nationalization on the incentives for the parties involved. For the financial institutions it might encourage recklessness since the government would intervene (e.g. by bailing out the company) in the event of bankruptcy. It raises the issue of moral hazard in business operations. When depositors know ex ante that the government is going to bail out large financial institutions whenever they fail, they have little incentives to monitor these institutions themselves due to the fact that they will not face any damage at all in case of a bail out by the government (Beck et al., 2010). The same argument applies to financial supervisory authorities. A bail out makes it unlikely that they will face any legal consequences from the depositors, as the latter have no damage. However, shareholders of the bailed out financial institution will incur damage, and may have an incentive to hold the financial supervisory authorities liable on grounds of shortcomings in their supervisory role. So, a bail out may limit some of the threat of tort law for the financial supervisory authorities and, as a consequence, mitigates the effectiveness of tort law as an incentive mechanism.

### 5.3.4 Tort law

Tort law can be seen as fulfilling two main functions, namely compensation and prevention (Van Boom, 2006). Standard law and economics theory predicts that the threat of tort law will give potential tortfeasors incentives to comply with the legal standards and thus prevent or discourage unlawful behaviour. By obliging the tortfeasor to compensate damages after the event, he is encouraged to act with the appropriate level of care before such an event could occur. The question arises whether tort law provides the various stakeholders in the case we examined with sufficient incentives in order to prevent the bankruptcy of a financial institution.

In the previous section we saw what the impact of a deposit guarantee system has on the incentives for financial supervisory authorities arising from tort law: these incentives may simply be reduced. Furthermore, there are so-called safeguard clauses between the financial supervisory authorities and the Ministry of Finance. Through the existence of these safeguard clauses, the financial supervisory authorities face a financial risk of only 10% of their budget when being held liable. As a result, the financial supervisory authorities will not face the full consequences despite being held liable. Financial supervisory authorities also have the opportunity to insure their financial risk which, if not sufficiently remedied by moral hazard, limits the financial impact of being held liable even further. As a consequence, the likelihood, and thus the threat, of being held liable diminishes. This can also be seen in practice. Dutch financial supervisors have, until now, never been convicted to pay compensation despite the fact that victims of bankrupted financial institutions have tried to hold them liable on grounds of supervisory failure in several cases. Overall, it is not likely that tort law will provide the Dutch financial supervisory authorities with sufficient incentives (Dijkstra, 2009).

The same line of reasoning applies to government liability except for the fact that the government is not able to insure their financial risk. There also exist no safeguard clauses for the government. Hence, if they are being held liable they face the total financial risk. The fact that financial supervisory authorities only face a 10% financial risk of their budget also increases the financial risk for the government. From this perspective, it is likely that the government will face more incentives from tort law when compared with the financial supervisory authorities. However, the existence of a deposit guarantee system reduces the incentives arising from tort law as the probability of being held liable diminishes. It is therefore unlikely that tort law will give the government sufficient incentives.

The final question that arises concerns the effects of tort law on the financial institutions and the depositors (taxpayers). A depositor could, in theory, still hold the financial institution or its chief officers liable for the losses suffered. Again, the problem of depositors being fully compensated by the deposit guarantee fund results in a lack of incentive to use tort law against the financial institution or its officers. However, when a depositor knows he will not be fully compensated by the deposit guarantee system, he has an incentive to monitor the financial institution he does business with. Given that in some legal systems, like in the Netherlands, the deposit guarantee system is very generous (guarantee up to € 100,000), one can not expect many incentives from tort law with depositors who have savings below that amount. We therefore expect that the incentives arising from tort law for both the financial institutions and depositors to be limited.

### 5.3.5 Submit claim to liquidator

When a depositor faces damage (because he had deposits which exceeded the deposit insurance) he or she might submit a claim to the liquidator. Because the outcome of the liquidation process is uncertain (the depositor does not know if or how much he will receive out of the liquidation) he has an incentive to monitor the financial institution he is doing business with. However, exactly the same problem arises here as with tort law: since the deposit guarantee system is comprehensive, the possibility of bankruptcy does not provide enough incentives for monitoring by depositors. Moreover, there is an abundance of economic literature on the effects of bankruptcy laws, showing precisely how (financial) institutions may use the bankruptcy system (e.g. to restructure) (White, 2008). Hence, submitting a claim to the liquidator will not lead to any incentives for financial institutions. The same goes for the government and the financial supervisory authorities: it is not likely that they will receive incentives from the fact that a depositor might submit its claim to a liquidator.

### 5.3.6 Conclusion

The above analysis shows that the existence of a deposit guarantee system can to a large extent dilute incentives for monitoring the behaviour of financial institutions. One can expect that this conclusion may particularly affect the behaviour of depositors more, since a guarantee system effectively removes risk from them. To some extent it may equally lead to moral hazard on the side of the financial institution itself. Also, since depositors will be fully compensated (depending upon the generosity of the system), financial supervisory authorities or the government no longer face the threat (and corresponding incentives) from tort law. This may also negatively affect their incentives.

Similar problems may arise in the case of a bailout or nationalization. A major difference is, however, that the deposit guarantee system is of a structural nature and hence provides certainty *ex ante* to depositors, whereas this is less the case with a bailout system. Where a bailout system may be in favour of larger financial institutions (too big to fail), a deposit guarantee system may, to the contrary, favour smaller institutions: it makes it attractive for smaller entities with lower start-up costs to enter the market (e.g. through internet banking), offering very attractive conditions (e.g. high interest rates) to potential clients. An effect of the deposit guarantee system is that clients need no longer *ex ante* to worry about the financial viability of the institution and, hence, have no incentive to monitor the solvency or operations of the institutions. One could expect that the more generous a deposit guarantee system is, the more it would become attractive for smaller, low operation-cost institutions to enter the market and offer high interest rates and engage in risky behaviour.

Of course there are other mechanisms affecting incentives of financial institutions which we did not incorporate. One issue, related to the deposit guarantee system is that the system is financed by the financial institutions. However, contrary to what theory predicts, the contributions do not seem to be risk related. Instead, they are largely related to the size of the market share of a financial institution, once more favouring smaller financial institutions. Second, the incentives of financial institutions are also affected by corporate governance, specifically the control exercised by shareholders on directors and by the market of corporate control (Pacces, 2008). Moreover, financial institutions can not simply enter the market, try to acquire a large share of customers by offering attractive interest rates, obtain large profits and dividends, and, subsequently, go bankrupt. There is a detailed financial and solvency regulation which, to some extent, limits excessive risk taking by financial institutions. However, these financial regulations often provide a minimum protection; beyond following the mandatory regulation, financial institutions still have a large amount of discretion on how to invest, how to attract clients, what type of interest rates to offer, etc.

## *5.4 Improving the current compensation system from an incentive perspective*

### 5.4.1 Introduction

We have seen that it is unlikely that the current compensation structure will provide adequate incentives for the stakeholders involved. In order to solve this problem, we suggest making adjustments to the current system. From this perspective we have to take a closer look at both the deposit guarantee system and tort law. With regard to the deposit guarantee system this means that we can think about changing the amount of coverage (which implies shifting the balance from the deposit guarantee system to the use of tort law), introducing co-insurance, and introducing risk based contributions, or a combination of these three adjustments. Regarding tort law we might think about abandoning it or replacing it with a system of first party insurance. In the sections below we will outline the possible consequences of these adjustments on the incentives for all parties involved.

### 5.4.2 Deposit guarantee system

As we indicated in Section 5.3.2, there are a few inefficiencies in the current deposit guarantee system, at least as far as providing incentives to the parties involved is concerned. The most obvious way to improve the incentives is by lowering the amount of coverage of the deposit guarantee system. By lowering the coverage level, depositors will face more risk and hence will have more incentives to monitor the financial institutions they are doing business with more carefully. Furthermore, a lower coverage level will also have a positive effect on the incentives of financial institutions. It is likely that a lower coverage level will result in less moral hazard and, therefore, in less riskier activities by financial institutions. Lowering the coverage level also implies shifting the balance from the deposit guarantee system to the use of tort law. The chance that a depositor is not fully compensated by the deposit guarantee system increases when the coverage level decreases. Therefore, it is likely that depositors will use tort law more often (by holding the financial supervisory authorities or government liable) in order to get compensation. As a result, both the government and financial supervisory authorities will face a greater risk of being held liable and, consequently, will have more incentives to keep a close watch on the behaviour of financial institutions. So, lowering the coverage level of the deposit guarantee fund is obviously the first best solution for improving the incentives for all parties involved.

However, we have seen that within the framework of the EC Directive, the possibilities of lowering the guaranteed amount are limited: the amount which currently (in 2009) has to be guaranteed is € 50,000, whereas € 100,000 is now guaranteed under the Dutch system. Theoretically, the coverage could be reduced to € 50,000, but that would only be a short-term solution: by December 2010, the coverage for aggregate deposits will – as a result of a change in the Directive - have to be € 100,000 anyway. Moreover, the difference would merely be symbolic as we previously indicated that the average deposit account in the Netherlands amounts to € 9,357. A reduction from € 100,000 to € 50,000 would not make much of a difference. Lowering the coverage level under current European legislation is not possible.

Second to lowering the coverage level of the deposit guarantee system, we could introduce a deductible (referred to as co-insurance), whereby a part of the loss would still be carried by the depositor. This adjustment also results in greater financial risk for depositors, forcing them to monitor their financial institutions more closely. Under a co-insurance, depositors will not be fully compensated by the deposit guarantee system. Therefore, it is likely that they will try to hold the government or the financial supervisory authorities liable in order to receive full compensation. The threat of tort law will increase, resulting in more incentives for financial supervisory authorities and government. It is not likely that financial institutions will face incentives to lower the riskiness of their operations based only on the introduction of co-insurance. However, the EC directive 2009(14) has abandoned the possibility of introducing co-insurance. So, this adjustment to the existing deposit guarantee system is also not possible under current European legislation

Another possibility refers to the financing of the deposit guarantee system. Currently, the level of contribution of each financial institution is simply based on their market share, and is not risk related at all. We indicated above that in other European countries, the contributions of the financial institutions to the deposit guarantee system are risk related. Such a system would obviously provide better incentives to financial institutions and is, therefore, a more likely candidate for improving the system. But what are the consequences for the government, financial supervisory authorities and depositors? It is not likely that risk based contributions have a direct impact on the incentives of the government, financial supervisory authorities and depositors.

### 5.4.3 Tort law

One of the most rigorous adjustments to the current system that could be pursued under current legislation is abandoning the use of tort law. This means that depositors are not able to hold the financial supervisory authorities or the government liable in case a financial institution goes bankrupt. How may this affect the incentives of the various stakeholders involved? Abandoning the use of tort law will obviously have a negative impact on the incentives for the government and the financial supervisory authorities since they no longer face the threat of being held liable. However, we have mentioned in the previous section that both the government and the financial supervisory authorities already face few incentives from the use tort law due to the existence of a deposit guarantee system. Hence, abandoning the use of tort law has, in our opinion, no major impact on the current incentives of the government and financial supervisory authorities.

How would this affect the incentives of depositors? Depositors will have more incentives to monitor financial institutions since they will lose a mechanism to get compensation for damage that exceeds the coverage level of the deposit guarantee system. Depositors with savings that exceed the coverage level run a greater risk of not getting fully compensated in case of a bankruptcy. In this case, one would expect depositors to look more carefully at the financial institutions they are doing or are willing to do business with. However, we must not overstate this positive effect on the incentives of depositors as it only applies to a relatively small amount of depositors (those in excess of € 100,000).

Financial institutions will receive no direct incentives from the fact that depositors are not able to hold the government and financial supervisory authorities liable in case of their bankruptcy. However, they might receive indirect incentives. We have noticed that depositors with savings that exceed the coverage level of the deposit insurance system will probably have more incentives to monitor the financial institutions. In order to keep these depositors as customers, financial institutions might want to lower the riskiness of their activities. Obviously the impact of this indirect incentive will largely depend on the number of customers who have deposit savings that exceed the coverage level. A financial institution that is largely dependent on wealthy clients will face more incentives to lower the riskiness of their activities compared to institutions that are less dependent of these kinds of clients.

Abandoning the use of tort law might therefore result in some minor improvements towards the incentives of depositors. However, due to the fact that tort law does not only fulfil functions with regard to compensation and prevention, but also to a feeling of justice in society, it remains questionable whether totally abandoning the use of tort law would be a socially acceptable solution.

A second option for reform is the replacement of tort law by first party insurance. First-party insurance is a system whereby insurance coverage is provided and compensation is awarded directly by the insurer to the victim. It is thus the potential victim who buys this type of insurance coverage, protecting himself from future harm and corresponding damages (Faure & Bruggeman, 2008). Hypothetically the depositors would choose to buy this kind of insurance. This means that in case of a bankruptcy of a financial institution, depositors are no longer able to hold the government or the financial supervisory authorities liable in order to receive compensation for the remainder of their damage, since tort would be replaced by a system of first party insurance.

The question arises how a first party insurance system would affect the incentives of the various stakeholders. Consider first the depositor. The depositor has to pay premiums in order to receive an amount of compensation above the coverage level arising from the deposit guarantee system. In order to provide incentives for the depositors, the amount of the premiums should be based on the riskiness of the financial institution where the depositor has placed his savings. In this way the depositor pays a higher premium if he places his savings in a riskier financial institution that offers higher interest rates. Once again, one should notice that this kind of insurance applies only to a relatively small group of depositors with deposits in excess of € 100,000. Instead of buying a first party insurance, a depositor could also allocate his savings to different financial institutions as the guaranteed amount of € 100,000 applies to each institution individually. This diversification could save the depositor the premium he would otherwise have to pay.

The question also arises of how a system of first party insurance affects the incentives of financial institutions. If insurance premiums are based on the riskiness of the financial institution where the depositor places his savings, financial institutions might modify some of their more risky practices. In order to keep their wealthy customers, e.g. those with saving deposits that exceed the coverage level of the deposit guarantee system, they may lower their operational risk in order to keep the insurance premiums for their main customers minimal.

Finally, the question arises of how this impacts incentives of the government and financial supervisory authorities. The more government is exposed under tort law, the more it will de facto act as insurer of the depositors. Being exposed to liability, government and financial supervisory authorities will have an incentive to take adequate measures in order to prevent failures of financial institutions. It is likely that governments want to prevent failures because failures will result in political costs. These measures might consist of tighter financial regulation or delegating more power to national financial supervisory authorities. However, under a system of first party insurance, which replaces tort law, it is not possible to hold the financial supervisory authorities liable. Thus, financial supervisory authorities and the government will not receive any incentives from tort law.

The demand for first party insurance coverage will depend upon the generosity of the deposit guarantee system (assuming that the two would be combined). Victims would only have a demand for first party coverage for losses not covered under the deposit guarantee system. Given that depositors can also allocate their savings to different institutions in order to limit their own risk, it is unlikely that there is a real demand for this kind of insurance coverage.

### *5.5 Conclusion and recommendations*

In this chapter we have analyzed, with the use of law and economics, the impact of the current compensation system on the incentives of depositors, financial institutions, financial supervisory authorities and government in case of the bankruptcy of a financial institution. An optimal compensation system should provide all stakeholders sufficient incentives for preventing the failure of a financial institution. Our analysis, similar to that of earlier studies in the US (Kam Hon Chu, 2003) and Europe (Groeneveld, 2009), predicts that the current compensation system in the Netherlands, mainly consisting of a combination of a deposit guarantee system and tort law, will not provide sufficient incentives for all stakeholders to prevent the failure of a financial institution. The existence of a deposit guarantee system has a negative impact on the incentives arising from tort law, due to a decrease in the likelihood that the government or financial supervisory authorities will be held liable. In order to improve the current compensation system with regard to incentives, we have suggested lowering the coverage level, introducing co-insurance, abandoning the use of tort law or replacing the role of tort law by a system of first party insurance, and changing the finance (funding) structure of the deposit guarantee fund.

The best solution is to lower the current coverage level of the deposit guarantee system. This would improve the incentives to all parties involved. However, under current European legislation, this is not possible. The same goes for introducing co-insurance, which is also not possible under the current EC directive. We strongly recommend the European Commission to take another look at this directive and its impact on the incentives for the various parties. Under current legislation only minor adjustments to the deposit guarantee system (of which the introduction of risk based premiums are most promising) are possible. Currently, all financial institutions in the Netherlands participate in the funding of the deposit guarantee system on the basis of their market share. A risk based premium setting could positively affect incentives of financial institutions.

We have also discussed the possibility of abandoning the use of tort law. In practice, tort law has no major role in compensating victims of bankrupted financial institutions due to the existence of the deposit guarantee system. From a compensation perspective, there are no strong arguments supporting the use of tort law. Our analysis shows that this shift will probably lead to more incentives for depositors that have deposits in excess of the coverage provided by the deposit guarantee system. However, since this specific group of depositors is relatively small, the impact will be minor. Abandoning the use of tort law will, on the other hand, negatively affect the incentives of financial supervisory authorities and government. This negative effect is, however, limited, considering the fact that the existence of a rather generous deposit guarantee system already results in a smaller likelihood that financial supervisory authorities or the government will be held liable. Due to the fact that tort law does not only fulfil functions with regard to compensation and prevention, but also to a feeling of justice in society, it remains questionable whether totally abandoning the use of tort law would be a socially acceptable solution.

Instead of abandoning the use of tort law, we discussed the introduction of first party insurance. A system of first party insurance could replace the role of tort law. Our analysis of this alternative showed that first party insurance is likely to give depositors more incentives to monitor financial institutions. The question remains, however, whether this alternative can be realized in practice as it relates to a relatively small group of depositors.

### *5.6 Commentary*

As this chapter was originally published in 2010 it does not take into account the change of legislation that took place in the Netherlands as of 1 July 2012. As of that date, the liability of the Dutch financial supervisory authorities was limited to cases of gross negligence and/or bad faith.[110] What does this change in legislation mean for the findings and conclusion of this chapter?

Chapter 5 mentions in Section 5.3.4 that, under a negligence regime, it is not likely that tort law will provide the Dutch financial supervisory authorities with sufficient incentives, as the actual liability threat is considered low. Introducing a gross negligence regime will not change this outcome, as this regime makes it even more difficult to hold the Dutch financial supervisory authorities liable. However, depositors will receive, in theory, more incentives to monitor financial institutions, since it has become more difficult to hold financial supervisory authorities liable. The latter impact should not be overrated, as it was also under a negligence rule difficult to hold the financial supervisory authorities liable.

Furthermore, Chapter 5 suggested to introduce a risk-based premium in order to improve the incentives of financial institutions. The Dutch parliament decided that, as of 1 July 2015, the funding of the Dutch Deposit Guarantee System will be based on ex ante risk-based premiums.[111]

[110] See article 1:25d of the Dutch Act on financial supervision.
[111] See http://www.tweedekamer.nl/kamerstukken/dossiers/kredietmarkt.jsp.

# 6 Is limiting financial supervisory liability a way to prevent defensive conduct? The outcome of a European survey

## *6.1 Introduction*

The liability of financial supervisory authorities in situations involving the performance of their public law supervisory tasks is a topic of recurring debate. Financial supervisory authorities have the complex task of monitoring the financial markets in order to reduce the probability of distress of individual financial institutions as well as on the entire financial system. In doing so, they face the possibility of being held liable by both third parties and financial institutions subject to their supervision, since they are often required to weigh delicate interests (Tison, 2003; Athanassiou, 2011).[112] The potential cases of supervisory liability towards financial institutions are often based on an overreaction on the part of the financial supervisory authority. By reacting too strictly, a financial supervisory authority can create damage, as its harsh intervention might affect the reputation of the financial institution under supervision and, in turn, weaken depositors' confidence. Where damage has been done in such a case, the financial institution can attempt to hold the supervisory authority liable, based on a too severe and thus unjustified intervention. However, if the authority acts too leniently, the financial institution can get into serious trouble that could eventually result in its bankruptcy. This is likely to cause damage for third parties, for which they will try to be compensated by suing the financial supervisory authority. The motives underlying their claims are often based on shortcomings in the way the supervisory authority exercised its supervision. It may be alleged, for example, that the authority, faced with indications of problems at the financial institution, should have acted more decisively to protect depositors (Nolan 2013).

At the centre of the debate regarding financial supervisory liability is the question of under what conditions and subject to what limitations financial supervisory authorities should be held liable (e.g., Athanassiou 2011). The Basel Committee on Banking Supervision suggested in 1997 (Principle 1) protection (normally in law) from personal and institutional liability for supervisory actions and/or omissions taken in good faith in the course of performing supervisory duties (Basel Committee on Banking Supervision, 1997).[113] Since then, an increasing number of member states have chosen to introduce criteria of gross negligence and/or bad faith to limit the liability of their supervisory authorities (Dijkstra, 2012).[114] But why should the liability of financial supervisory authorities be limited?

[112] In some countries the State (for instance in France) or the Ministry of Finance has to be held liable instead of the financial supervisory authority itself.
[113] The revised principles of September 2012 (Basel Committee on Banking Supervision 2012) still contain the principle of legal protection for supervisors and their staff (Principle 2).
[114] Most recently, in 2012 the Netherlands changed the liability regime of their financial supervisory authorities, the

One of the most important policy arguments for this limitation can be found in the concept of "defensive conduct" (e.g. Booth & Squires, 2005; Giesen, 2006; Van Dam, 2006; Delston & Campbell, 2007; Dragomir, 2010; De Mot & Faure, 2012). Politicians and many others are convinced that normal liability rules result in defensive conduct on the part of financial supervisory authorities.[115] The threat of huge damage claims would have a chilling effect on the performance of effective financial supervision. By limiting liability to cases of gross negligence or bad faith, this effect would be mitigated and hence result in more-effective financial supervision. This line of reasoning not only assumes that normal liability rules do influence the behaviour of financial supervisory authorities but also goes a step further by arguing that they will result in over-deterrence and, hence, defensive conduct. The deterrent effect of tort law on financial supervisory authorities is however highly debated, and to my knowledge, no overwhelming empirical evidence to support this effect exists (e.g. Marsh, 2008; De Mot & Faure, 2012).

Whether financial supervisory liability promotes more-effective financial supervision, encourages defensive conduct, or has no significant effect is at heart an empirical question.[116] This article therefore examines, in a European context, the impact of financial supervisory liability by means of empirical research. More specifically, it examines the widely used argument that limited financial supervisory liability prevents the occurrence of defensive conduct. Objective data on the impact of financial supervisory liability is, however, difficult to obtain. Therefore, the strategy adopted is to explore this topic through the perceptions of financial supervisors. This was performed through a survey of financial supervisors in the European Union. The survey results will assist in gaining a better understanding of how financial supervisory liability may affect the behaviour of financial supervisors or, at least, how it influences their perceptions.

The remainder of the paper is structured as follows. Section 6.2 discusses the economic analysis of public authority liability in general and addresses several key factors regarding financial supervisory authorities. This part makes clear that, from a theoretical perspective, the impact of financial supervisory liability is difficult to predict. Section 6.3 describes the methodological framework and data set that used to examine the impact of financial supervisory liability. Section 6.4 presents the results of

Dutch Central Bank (DNB) and the Financial Market Authority (AFM), by limiting their liability to cases of gross negligence or bad faith.

[115] In this paper normal liability rules are defined as negligence and no-fault.

[116] To my knowledge, Van Dam (2006) is the only one who has undertaken limited empirical research regarding the impact of liability that included financial supervisory authorities. Based on a short questionnaire and interviews with Dutch supervisory authorities, including the Dutch financial supervisors who, at that time, were bound to normal liability rules (negligence), Van Dam (2006) mentioned that, according to the statements of the supervisors, there was no indication for defensive conduct. Supervisors did, however, mention that they would include the outcome of court decisions in their policies in order to improve the quality of their supervision. Van Dam (2006) mentioned, furthermore, that none of the supervisory authorities asked for a limitation of supervisory liability.

the survey, followed by a discussion in Section 6.5. The conclusions are then presented in Section 6.6.

### 6.2 *Economic analysis of public authority liability*

This section discusses the economic analysis of public authority liability in general and addresses several key factors regarding financial supervisory liability. The economic analysis of tort law is traditionally concerned with providing incentives to individuals and firms to behave carefully. The reasoning is that the ex ante foresight of potentially being held liable will induce the rational, wealth-maximizing actor today to behave carefully (Cooter & Ulen, 2008). Only during recent years has the literature begun to address the economic analysis of public authority liability (e.g. Posner & Sykes, 2007; Dari-Mattiacci et al., 2010; Marsh, 2008; De Geest, 2011; De Mot & Faure, 2012). From this perspective, public authority liability provides incentives for careful behaviour.[117] In reality, the conviction has taken root among politicians and many others that normal liability rules result in too much pressure on financial supervisory authorities. As a consequence, normal liability rules would result in defensive conduct and, in turn, ineffective financial supervision (Delston & Campbell, 2007).[118] This line of reasoning is not new. The concept of defensive conduct is one of the traditional arguments against public authority liability used especially in commonwealth countries (Booth & Squires, 2005; Dari-Mattiachi *et al.*, 2010).

But what is actually meant by defensive conduct? A clear definition unfortunately does not exist (Marsh, 2008). Defensive conduct, or in this study defensive financial supervision, is often the result of a situation of over-deterrence. The fear of being held liable is, in this situation, so severe that one starts to act with too much caution when dealing with the supervisee. Thus, defensive financial supervision refers to any act or omission by financial supervisors that is performed not for the benefit of supervision but solely to avoid liability or to provide a good legal defense against a liability claim.[119] This can generally take two forms (e.g. Velthoven & Van Wijck, 2012).[120]

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[117] The economic analysis of public authority liability starts by taking the traditional economic model as a reasonable account of the way in which the tort system affects the private sector. The question, however, is to what extent the traditional economic model can be used for public authorities, as their objective, unlike those of corporations, is not profit maximization. Some scholars have therefore argued that the traditional economic model of tort law cannot be applied to public authorities (Levinson 2000; Schäfer 2012). Others have argued that public authorities face budget constraints that could result in a more or less similar response to liability as corporations (e.g., Niskanen 1971; Rosenthal 2006). This latter perspective is an application of the rational-choice model of bureaucratic behaviour that assumes that a bureaucrat will seek to maximize the size of her agency's budget. One could claim that, whatever underlying behavioural model one uses to characterize public authorities, public liability imposes some (political) costs upon these authorities that create incentives to prevent misconduct (Dari-Mattiacci *et al.* 2010).

[118] See fn 3.

[119] This definition has been derived from the definition of defensive medicine as used by Hauser et al. (1991). It is furthermore interesting to note that when discussing the concept of defensive conduct as a result from liability, defensive conduct itself might also result in liability. This is most likely the case when supervisory authorities engage in

First, supervisors can engage in fewer activities than desired. This will decrease the chance of being held liable by supervised financial institutions, while the risk of being held liable by third parties will probably not increase significantly, as bankruptcies of financial institutions, the main trigger for third party liability, are not that common in normal economic times. Second, defensive supervision can involve carrying out supervisory activities in a cost-inefficient, unproductive way. This occurs, for instance, when financial supervisors intensively involve legal experts in order to review their supervisory decisions before announcing and executing them. The use of extensive reviews by legal experts will likely limit the possibility of a successful lawsuit against the authority in a later stage, but it can also interfere with a fast and effective execution of financial supervision. Conversely, not all *thorough* financial supervision is necessarily defensive: Many other factors inspire thoroughness, including the quest for knowledge and improved data collection, and the belief that doing things thoroughly is, indeed, the best course of action for both the financial institutions under supervision and the third parties.[121]

How can the concept of defensive conduct be explained from a law and economic perspective? The keyword in this perspective is over-deterrence. The traditional economic model assumes that due care is set at the optimal level, and there is no uncertainty regarding this level of care (e.g. Cooter & Ulen, 2008). In the real world, however, legal standards are often uncertain. To determine the optimal level of due care, courts need complete and accurate information on the costs of care and the expected costs of accidents for each level of care. However, data necessary to set the optimal level of care will often be unavailable. In addition, courts will not always be able to properly observe the actual level of care exercised by the tortfeasor due to measurement errors, insufficient evidence, and misrepresentation about the actual level of care. Thus, only during a trial, when parties present the facts of the case, is the due level of care established in a more-precise way. As a result, tortfeasors exercising a certain level of care might not know ex ante whether or not they will be found negligent. This also applies to financial supervisory authorities.

From case law and literature, it becomes clear that the standard for financial supervisory authorities under a negligent liability rule is "reasonable care."[122] This

fewer activities and, as a consequence, fail in performing their supervisory tasks.

[120] This also relates to the distinction made between care-level deterrence and activity-level deterrence, where the first concerns the degree to which a potential tortfeasor exercises care, and the second concerns the extent to which a potential tortfeasor engages in an activity that creates tort risks even when done carefully (Shavell 1980).

[121] In addition, thoroughness in performing financial supervision can also be impacted by differences in mandates of financial supervisory authorities.

[122] See, for instance, the Supreme Court of the Netherlands in the Vie d'Or case. In order to determine whether financial supervision complies with the standard of reasonable care, all circumstances of the individual case have to be taken into account. These circumstances are the 'nature' of financial supervision: the fact that financial supervisors have discretionary powers in order to fulfill their supervisory duties, and the fact that financial supervisors face the difficult task of taking into account both the interests of the supervised institutions and society (supervisors' dilemma).

standard is surrounded by uncertainty, given the facts that financial supervisors have discretionary powers to fulfill their supervisory duties and face the difficult task of taking into account both the interests of the supervised institutions and the individual members of society. What does this mean for the deterrent effect of tort law? Uncertainty regarding the level of due care changes the deterrent impact of legal rules by creating two opposing effects (Craswell & Calfee, 1986). The first effect is an incentive to over-comply. However, uncertainty also creates a chance that a tortfeasor will not be held liable, thus reducing the incentives to comply with the legal standard. The question thus created is which effect will prevail. Standard law and economic theory predict that over-deterrence (and thus defensive conduct) will occur (Craswell & Calfee, 1986). Scholars have argued that this is even worse when a public authority is involved due to the fact that, unlike private tortfeasors, a public authority typically balances two external costs, as it does not bear the costs of over-precaution. Public authorities are therefore much more quickly inclined towards taking an overabundance of precaution (e.g. De Geest, 2011; De Mot & Faure, 2012).

The existence of uncertainty regarding the standard of due care for financial supervisory authorities might explain why politicians and many others fear over-deterrence and thus defensive conduct on the side of financial supervisory authorities. By limiting the liability of financial supervisory authorities to cases of gross negligence and/or bad faith, they argue, the standard of care becomes clearer, and hence would result in limiting over-deterrence and thus defensive conduct.

Despite the fact that this line of reasoning sounds attractive, it fails to incorporate one other important factor, namely, the existence of an alternative mechanism for compensation (Dijkstra, 2009). Most countries have in place a deposit guarantee system that offers compensation to depositors in the event of the bankruptcy of a financial institution. The standard economic model of tort law assumes, however, that tort law is the only mechanism capable of obtaining compensation for losses (Cooter & Ulen, 2008). It is important that the potential tortfeasor internalizes all the costs of his or her behaviour. Otherwise, he or she will receive an incentive that is less than optimal and, as a consequence, will engage in less-cautious behaviour. Based on the European Council Directive 94/19/EC of May 1994 as amended by Directive 2009/14/EC, member states are required to implement a deposit guarantee system with a minimum compensation of € 100,000. The primary objective of any deposit guarantee scheme is to provide protection, allowing depositors to be repaid quickly should a financial institution fail. But what is the influence of such guarantee systems on the deterrent effect of tort law?

As mentioned earlier, financial supervisory authorities face liability threats from both the financial institutions under supervision and third parties. The threat of being sued by the latter group is most likely to occur when a financial institution goes bankrupt.

The existence of alternative compensation by means of a deposit guarantee system will then decrease the liability threat for financial supervisory authorities from this particular group. Depending on the amount of losses arising from the bankruptcy of a financial institution, depositors faced with losses will always receive full or partial compensation through the deposit guarantee scheme. Only if their losses were (much) greater than the compensation from the deposit guarantee fund would they have an incentive for holding the financial supervisory authority liable. As a consequence, the existence of a deposit guarantee scheme will eliminate some of the potential liability threat from third parties resulting in under-deterrence (Dijkstra, 2009).

Furthermore, it is important to note that public authorities themselves do not commit harmful acts; people do. Public authority liability involves the imposition of liability on the organization itself due to the harmful behaviour of its employees. However, making the public authority liable may fail to provide its employees with sufficient incentives to act carefully, as the sanctions imposed on the organization might not reach the responsible individuals (Dijkstra, 2009; Dari-Mattiachi *et al.,* 2010).[123] The question of whether incentives are transferred from the organization to its agents is a manifestation of the well-known agency problem between organizations and their employees. The challenge for public authorities is, therefore, one of overcoming principal–agent problems. This principal–agent problem undermines the production of adequate incentives and questions, therefore, the deterrent effect of public authority liability (Croley, 1996).

The factors mentioned influence the deterrent impact of tort law in opposite ways. While a vague standard of due care is likely to result in over-deterrence, the existence of a deposit guarantee system and principal-agent issues are likely to have a mitigating effect on the deterrent impact of tort law. This clearly shows that it is difficult, if not impossible, to estimate the net impact of financial supervisory liability from a theoretical perspective. It is, therefore, interesting to see how financial supervisors themselves perceive the impact of financial supervisory liability by conducting empirical research.

## *6.3 Methodology and data*

### 6.3.1 Introduction

This study explores the impact of financial supervisory liability on financial supervisors. More specifically, it examines the widely used argument that limited financial supervisory liability prevents defensive conduct from happening. An ideal

[123] Some financial authorities can, in theory, initiate recourse actions against individual supervisors in case they have been found liable by courts. This could provide individual supervisors incentives for taking adequate care.

research design would observe the actual behaviour of financial supervisors under different liability regimes. This can be done by examining jurisdictions with different levels of tort liability or a single jurisdiction that has shifted from one form of liability rule to another. As the financial supervisory liability regimes in the member states of the EU range from no-fault liability to immunity, I have chosen to examine the impact of financial supervisory liability by making use of these different jurisdictions.[124] However, objective data on the actual behaviour of financial supervisors is difficult, if not impossible, to obtain. Therefore, the strategy I adopted is to address the research questions through the perceptions of senior financial supervisors. This was done with a survey of financial supervisors in the European Union, which is described in the next paragraph.

### 6.3.2 Survey design[125]

The survey comprises three parts. The first part collects information about the characteristics of the respondents. The survey asked respondents in what country they operate *(question 1)* and to which financial supervisory authority they belong *(question 2)*. Furthermore, the survey asked respondents about their current position in the organization *(question 3)*, how long they have worked in their organization *(question 4),* and in what category of financial supervision they are active *(question 5)*.

The extent to which financial supervisors are deterred is most likely dependent on the (perceived) threat from liability. The second part of the survey consists, therefore, of eight general questions and one statement related to the liability of the financial supervisory authority. An initial question raised was whether the organization could be held liable *(question 6)*. The answers on this question define the data set, as the analysis will be based on the answers of those respondents who think that their organization can be held liable or do not know whether this is possible.[126] Subsequently, the survey asked whether the organization has been held liable in the past five years *(question 7),* and if this was the case, how often this has occurred *(question 8)*, by whom the organization was held liable *(question 9),* and how often a court has established liability and sentenced the authority to compensate damages *(question 10)*. Furthermore, the survey asked financial supervisors about the existence of any limitations of financial supervisory liability *(question 11)*. The answers to the latter question will be used to measure any differences in answers on the impact of financial supervisory liability between financial supervisors who perceive the liability of their organization as limited

[124] See Dijkstra (2012) for an overview of the financial supervisory liability regimes in the European Union.

[125] A preliminary survey was designed and tested by two financial supervisory authorities, namely, the Croatian National Bank and the Norwegian Financial Supervisory Authority. The helpful comments and recommendations I received from those two authorities were used to finalize the survey. For the complete survey, I refer to Appendix 5.

[126] If financial supervisors don't believe that their organization can be held liable, it is unlikely that (the threat of) liability has any impact at all on their behaviour.

and those who do not (dependent variable).[127] Where a limitation was indicated, the survey also sought to find out what kind of limitation was applicable *(question 11a)*. The survey also included a statement that asked respondents if they view their decisions and actions as a potential lawsuit for the organization *(statement 1)*. This statement offers an indication of the level of liability threat.

The third and main part of the survey focuses on the actual impact of financial supervisory liability. Studies regarding the impact of liability or specific changes in the liability regime of public authorities are rare. This part of the survey is therefore based on insights from empirical research in the field of defensive medicine (e.g. Suddert *et al*., 2005; Nahed *et al*., 2012). It consists of eight statements that can shed some light on how financial supervisors perceive the impact of financial supervisory liability and, depending on the answers, on the existence of over-deterrence and/or defensive conduct.[128] Respondents were asked to reply by means of a 5-point Likert-type scale anchored at the low end by "strongly disagree" and at the high end by "strongly agree."[129] The survey asked, for instance, whether financial supervisors see any concrete impact of financial supervisory liability on the supervisory activities of their organization at all *(statement 8)*. If there is an impact of financial supervisory liability, it is likely that this will result in changed internal policies *(statement 2)*. Where changes have been indicated, the survey also sought to find out whether this was done merely to mitigate the risk of future lawsuits *(statement 2b)* or to improve the effectiveness of financial supervision *(statement 2a)*. As mentioned earlier, defensive conduct can generally take two forms, namely, a reduction of (socially desired) activities *(statement 3)* or overly cautious behaviour when engaging in activities. An example of the latter is the extensive involvement of legal experts before decisions are made *(statement 4)*. To examine whether this involvement is considered counterproductive, the survey asked whether the involvement of legal experts increased the quality of financial supervision *(statement 4a)* or prevented financial supervisors from reacting fast *(statement 4b)*. Furthermore, the survey included three general statements about the impact of financial supervisory liability *(statements 5, 6 & 8)*. One can assume that financial supervisors who face over-deterrence are more willing to change the existing liability regime and to be more negative about the overall impact of financial supervisory liability. Answers related to these statements can therefore be considered as an indication of the existence of over-deterrence and, therefore, defensive financial supervision.

[127] To examine whether there are any statistically significant differences between financial supervisors who perceive the liability of their organization as limited and those who do not, I performed a Mann-Whitney U test. The Mann-Whitney U test is a non-parametric test used to determine if a difference exists between two groups.
[128] These eight statements cannot be considered as a scale of defensive conduct and need, therefore, to be judged individually.
[129] The intermediate steps include 'Agree', 'Neutral,' and 'Disagree'.

### 6.3.3 Survey participants

The survey was sent to 706 senior financial supervisors working in 48 financial supervisory authorities in 27 member states of the EU.[130] I have chosen to focus on senior, high-ranking employees, as their perceptions are most likely to influence the rest of the organization.[131] The individual subjects were identified using the organizational charts from the websites of financial supervisory authorities and the website Linkedin. The survey was administered using LimeSurvey, a subscription web service that provides tools for building and administering surveys and for storage of the resulting data.[132] Subjects were given a link to the survey residing on the LimeSurvey site via email. After the first electronic mailing in May 2013, 197 messages were returned due to incorrect addresses, leaving an active sample of 509 financial supervisors. Approximately two weeks after the initial mailing, a reminder was sent. This was followed by a final reminder at the end of June. A total of 119 individuals completed the survey between May and July 2013, resulting in an overall response rate of 23.4%.[133] All 27 member states of the EU are represented in the responses.[134] Of the 48 financial supervisory authorities, only three did not respond.[135] Furthermore, six financial supervisory authorities decided to reply with only one "organizational" response instead of individual responses by the invited senior employees. In my analysis, I have treated their responses as individual responses.

### 6.3.4 Data set

It is not likely that respondents who believe that their organization cannot be held liable are influenced by the threat of liability.[136] In order to examine the impact of financial supervisory liability, I will therefore use only the answers of respondents who believe, or, who don't know, that it is possible to hold their organization liable (question 6). From table 9, it becomes clear that this data set contains 105 respondents

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[130] Because the survey was conducted in the period May – July 2013, Croatia, which became the 28th member state of the EU as of 1 July, was not included. In this study, financial supervisory authorities are defined as organizations performing the public law task of financial supervision in one or more of the following areas: banking supervision, insurance supervision, pension supervision, and securities supervision. For an initial overview of these authorities, see Dijkstra (2012).

[131] Members of the executive board, directors, and managers of financial supervisory authorities are those most likely to make the most important decisions and shape internal policies.

[132] See www.limesurvey.com.

[133] The response rate may be relatively low, but it can be argued that the specialist nature of the group being surveyed does not lead to bias in the results: see Leslie L., 'Are high response rates essential to valid surveys?' (1972) 1 *Social Science Research* 323. Moreover, it should be noted that this response rate could be considered normal and adequate with respect to online surveys amongst a widely differentiated group.

[134] The median number of responses per member state was 4 (min = 1, max = 11), while the median number of responses per financial supervisory authority was 2 (min = 1, max = 11).

[135] The three financial supervisory authorities that did not respond were the French Prudential Supervisory Authority (Autorité de Contrôle Prudentiel), the Luxembourg supervisory and regulatory authority of the insurance and reinsurance sector (Commissariat aux Assurances), and the Bank of Spain (Banco de España).

[136] The survey did not collect any other answers from respondents who believed that it was not possible to hold their organization liable.

(88% of total respondents).[137] The characteristics of these respondents and the analysis of their answers will be described in Section 6.4.

**Table 9: Defining the data set for analysis.**

| Is it possible to hold your organization liable? | *N* | % of total |
|---|---|---|
| Yes | 88 | 74% |
| No | 14 | 12% |
| I do not know | 17 | 14% |

### 6.3.5 Limitations

Using this method of online questioning of financial supervisors in the European Union, I have accessed an important source of information; however, the findings have to be qualified in two respects. As with all survey data, the responses reflect the reality as observed and perceived by the financial supervisors; perceptions may differ from actual practice patterns. The answers of the respondents may also be biased toward giving a socially desirable response or achieving political goals (Suddert et al., 2005). However, if there is no difference in the answers between financial supervisors who perceive the liability of their organization as limited and those who do not, bias is not likely to play an important role. Furthermore, the nature of the questions and statements and the wide variety of jurisdictions of the respondents result in a set of responses on a highly aggregate level. There is a danger that certain factors of influence in a particular jurisdiction have not been captured in the survey. As a result of these limitations, one should be careful in using the findings. The outcome of this study provides only a general indication of the impact of financial supervisory liability.

## *6.4 Survey results and analysis*

### 6.4.1 Characteristics of the respondents

The respondents in the data set represent 27 member states of the European Union and 43 (out of a targeted total of 48) financial supervisory authorities. Table 10 reveals that the respondents covered, in more or less equal distribution, all financial supervision areas. The areas of banking supervision (30%) and securities supervision (30%) are represented most often, followed by the areas of insurance supervision (21%) and pension supervision (17%).

[137] The data set of 105 respondents reflects 27 member states and 43 financial supervisory authorities. The complete data package (n = 119) reflects 27 member states and 44 financial supervisory authorities.

**Table 10: Characteristics of the respondents.**

| | N=105 | % of total |
|---|---|---|
| Representation of area of supervision:* | | |
| Banking supervision | 57 | 30% |
| Insurance supervision | 40 | 21% |
| Pension supervision | 33 | 17% |
| Securities supervision | 57 | 30% |
| Other | 3 | 2% |
| Respondents' roles in organization: | | |
| Member executive board | 8 | 8% |
| Director | 32 | 30% |
| Manager | 24 | 23% |
| Senior supervision professional | 18 | 17% |
| Support staff | 5 | 5% |
| Legal expert | 17 | 16% |
| Other | 1 | 1% |
| Respondents' work experience: | | |
| < 5 years | 33 | 31% |
| 5 – 10 years | 29 | 28% |
| 10 – 15 years | 24 | 23% |
| > 15 years | 19 | 18% |

** Respondents can be active in multiple areas of supervision (therefore, N ≠ 105).*

The survey targeted senior financial supervisors, as their perceptions are most likely to have the greatest influence in the organization since they can be considered as the decision makers within the organization. Table 10 shows that most of the respondents fall within this category. Almost 38% belong to the top level (executive board and directors), while 40% belong to the senior level (managers and senior supervision professionals). The relatively high percentage of legal experts (16%) can be explained by the topic of the survey.

Most of the respondents in the data set report significant work experience in their current organization. Almost 18% of the respondents have worked more than 15 years in their organization. Another 51% of those in the data set have between five and 15 years of experience. Only 31% of the respondents has relatively little experience, defined as less than five years in their current organization.

### 6.4.2 The impact of financial supervisory liability

Do the respondents see any impact of financial supervisory liability? Table 11 reveals that only 25% of the respondents agree with the statement: I do not see any concrete impact of a threat of supervisory liability on the supervisory activities of my organization, while 40% of the respondents disagree with this statement.

**Table 11: Impact of financial supervisory liability.**

| | N | Strongly disagree | Disagree | Neutral | Agree | Strongly agree |
|---|---|---|---|---|---|---|
| I do not see any concrete impact of a threat of supervisory liability on the supervisory activities of my organization. | 105 | 3% | 37% | 35% | 19% | 6% |

Thus, it seems that a significant number of respondents believe that financial supervisory liability has an impact on financial supervision. This is also confirmed by the answers on the next statement. Table 12 shows that 39% of the respondents are convinced that financial supervisory liability has changed their internal policies, indicating that liability does have an impact.

**Table 12: Impact on internal policies.**

| | N | Strongly disagree | Disagree | Neutral | Agree | Strongly agree |
|---|---|---|---|---|---|---|
| Financial supervisory liability cases have changed our internal policies regarding the way we perform our supervisory tasks. | 105 | 13% | 18% | 30% | 33% | 6% |
| The changed internal policies improve the effectiveness of our financial supervision. | 72 | 0% | 8% | 50% | 35% | 7% |
| The purpose of the changed internal policies is to mitigate the risk of future lawsuits. | 72 | 1% | 4% | 39% | 42% | 14% |

Despite the fact that a significant number of respondents believe that financial supervisory liability has an impact on financial supervision, it is not clear how they perceive this impact. Therefore, the survey also sought to find out whether the policies were changed in order to improve the effectiveness of financial supervision or merely to mitigate the risk of a future lawsuit. From table 12, it becomes clear that 42% of the respondents believe that the changed policies contribute to the effectiveness of financial supervision; only 8% disagree with this statement. Furthermore, the majority of the respondents agreed with the statement that the purpose of the changed internal policies is to mitigate the risk of future lawsuits.

As mentioned in the previous section, defensive conduct generally takes two forms. First, over-deterrence could result in fewer activities. Therefore, the survey asked whether financial supervisory liability results in fewer activities than desired.

**Table 13: Level of supervisory activities.**

| | N | Strongly disagree | Disagree | Neutral | Agree | Strongly agree |
|---|---|---|---|---|---|---|
| The existing threat of supervisory liability results in fewer supervisory activities than desired. | 105 | 27% | 43% | 19% | 10% | 2% |

Table 13 shows that most of the respondents (70%) disagreed with the statement. It seems that financial supervisors are convinced that the level of their activities is not negatively affected by financial supervisory liability.

Defensive supervision can also involve carrying out supervisory activities in a cost-inefficient, unproductive way. This occurs, for instance, when financial supervisors intensively involve legal experts in order to review their supervisory decisions before announcing and executing them. Therefore, the survey asked whether every decision needs to be checked with the legal department before being announced or published.

**Table 14: Use of the legal department.**

| | N | Strongly disagree | Disagree | Neutral | Agree | Strongly agree |
|---|---|---|---|---|---|---|
| Every supervisory decision has to be checked with our legal department (internal or external) before being announced or published. | 105 | 2% | 19% | 19% | 42% | 18% |

The majority of respondents (60%) agreed with the statement. This could indicate the existence of defensive conduct. Subsequently, the survey asked respondents who agreed with this statement (n = 63) whether they thought that the involvement of the legal department increased the quality of supervision or prevented them from reacting fast when that is required (Table 15).

**Table 15: Perceptions on the involvement of the legal department.**

| | N | Strongly disagree | Disagree | Neutral | Agree | Strongly agree |
|---|---|---|---|---|---|---|
| The involvement of our legal department increases the quality of our financial supervision. | 63 | 0% | 0% | 16% | 59% | 25% |
| The involvement of our legal department prevents us from reacting fast when that is required. | 63 | 14% | 30% | 38% | 16% | 2% |

It is interesting to see that 84% of these respondents are convinced that the involvement of their legal department increases the quality of financial supervision, while only 18% think that this involvement prevents them from reacting quickly. So despite the fact that supervisory decisions need to be checked by the legal department, financial supervisors don't perceive this as a negative for performing financial supervision.

One could further assume that in a situation of over-deterrence, financial supervisors are more likely to be more negative when asked about the impact of financial supervisory liability. Therefore, the survey asked the respondents about their view on the impact of financial supervisory liability.

**Table 16: Impact of financial supervisory liability.**

| | N | Strongly disagree | Disagree | Neutral | Agree | Strongly agree |
|---|---|---|---|---|---|---|
| The existing liability regime has a positive impact on the quality of financial supervision. | 105 | 2% | 6% | 52% | 38% | 2% |
| The existing liability threat results in more careful supervisory decisions. | 105 | 1% | 11% | 42% | 44% | 2% |
| Our organization would be more effective without the threat of liability. | 105 | 6% | 37% | 45% | 10% | 2% |

As Table 16 indicates, most respondents consider the impact of financial supervisory liability to be a neutral or positive one. Of the respondents, 40% think that the existing liability regime has a positive impact on the quality of financial supervision while 46% of the respondents believe that the existing liability threat results in more careful supervisory decisions. Only 12% of the respondents agreed with the statement that their organization would be more effective without the threat of liability. This indicates that the majority of the respondents is content with the existing situation and do not see any reason to change it.

At most, the evidence from the survey implies an arguably modest degree of deterrence. Most financial supervisors classify the impact of financial supervisory liability as neutral or positive. It seems, therefore, that financial supervisors generally don't see financial supervisory liability as a burden for performing effective financial supervision.

### 6.4.3 The influence of liability limitations

The previous section indicated that most of the respondents consider the impact of financial supervisory liability to be neutral or positive. However, this analysis does not take into account the potential differences in perceptions between respondents who believe the liability of their organization is limited and those who do not. If the argument that limited liability would prevent defensive conduct from happening is true, one would expect to see differences between these groups. More specifically, one would expect that respondents who think that the liability of their organization is not limited are more negative about the impact of financial supervisory liability than those who do not.

Therefore, the survey asked respondents about the existence of liability limitations regarding their organization *(question 11)*. The answers to this question (Table 17) show that 35% of the respondents think that the liability of their organization is limited, while 32% of the respondents believe that this is not the case; 32% of the respondents do not know whether there are limitations in place. A closer examination of the answers of those respondents who believe that the liability of their organization is limited (n = 37) indicates that this limitation is often based on rules of gross negligence and/or bad faith.

**Table 17: Financial supervisory liability limitations.**

| Are there any limitations of financial supervisory liability regarding your organization, that you know of? | N | % of total |
|---|---|---|
| Yes | 37 | 35% |
| No | 34 | 32% |
| I do not know | 34 | 32% |

In order to examine any significant statistical differences between financial supervisors who perceive the liability of their organization as limited and those who do not, I conducted a Mann-Whitney U test. This test is based on the independent survey variable "Are there any limitations of financial supervisory liability that you know of?" For this test, the answers "No" and "I do not know" have been combined, as none of these respondents perceive any limitation of liability.

**Table 18: Mann-Whitney U test on the impact of perceived liability limitations.**

| | N | U | Z | p-value |
|---|---|---|---|---|
| (2) Financial supervisory liability cases have changed our internal policies regarding the way we perform our supervisory tasks. | 105 | 1060 | -1.38 | 0.168 |
| (2a) The changed internal policies improve the effectiveness of our financial supervision. | 72[1] | 425 | -1.32 | 0.188 |
| (2b) The purpose of the changed internal policies is to mitigate the risk of future lawsuits. | 72[1] | 508 | -1.62 | 0.871 |
| (3) The existing threat of supervisory liability results in less supervisory activities than desired. | 105 | 1241 | -0.12 | 0.901 |
| (4) Every supervisory decision has to be checked with our legal department (internal or external) before being announced or published. | 105 | 1192 | -0.46 | 0.642 |
| (4a) The involvement of our legal department increases the quality of our financial supervision. | 63[2] | 399 | -0.85 | 0.395 |
| (4b) The involvement of our legal department prevents us from reacting fast when that is required. | 63[2] | 313 | -2.09 | 0.036* |
| (5) The existing liability regime has a positive impact on the quality of financial supervision. | 105 | 1132 | -0.95 | 0.343 |
| (6) The existing liability threat results in more-careful supervisory decisions. | 105 | 971 | -2.10 | 0.036* |
| (7) I do not see any concrete impact of a threat of supervisory liability on the supervisory activities of my organization. | 105 | 1152 | -0.75 | 0.453 |
| (8) Our organization would be more effective without the threat of liability. | 105 | 1163 | -0.69 | 0.489 |

* Statistically significant $p < 0.05$
[1] Number of respondents who answered 'neutral,' 'agree,' or 'strongly agree' on statement (1)
[2] Number of respondents who answered 'agree' or 'strongly agree' on statement (4)

The Mann-Whitney U Test revealed a statistically significant difference regarding statement 4b between financial supervisors who perceive the liability of their organization as limited (Md = 2, n = 22) and those who do not (Md = 3, n = 41), U = 311, z = - 2.09, p = 0.036, r = - 0.26. Respondents who perceive the liability of their organization as limited are more convinced that their legal department does not have a negative impact on the speed of their reaction. Furthermore, the Mann-Whitney U

Test revealed a statistically significant difference regarding statement 6 between financial supervisors who perceive the liability of their organization as limited (Md = 3, n = 37) and those who do not (Md = 3.5, n = 68), U = 971, z = - 2.10, p = 0.036, r = - 0.20. Respondents who do not perceive the liability of their organization as limited are slightly more positive about the impact of financial supervisory liability regarding the level of careful supervisory decisions.

The overall outcome of this Mann-Whitney U test suggests that limiting financial supervisory liability doesn't have an impact on the behaviour, or at least on the perceptions, of financial supervisors. Both groups share the same neutral or positive perception on the impact of financial supervisory liability. The study therefore calls into question the widely accepted argument of defensive conduct for limiting the liability of financial supervisory authorities.[138]

### *6.5 Discussion*

The previous section showed that most respondents, independent of their view on liability limitations, consider the impact of financial supervisory liability to be neutral or positive. How can this outcome be explained? A possible explanation can be found in the level of liability threat. The survey asked if respondents viewed every supervisory decision as a potential lawsuit for their organization.

**Table 19: Liability threat.**

| | N | Strongly disagree | Disagree | Neutral | Agree | Strongly agree |
|---|---|---|---|---|---|---|
| I view every financial supervisory decision/action as a potential lawsuit for my organization. | 105 | 10% | 36% | 16% | 31% | 7% |

The outcome in table 19 shows that 46% of the respondents disagreed with the statement, while 38% agreed with the statement. The answers could indicate that the overall liability threat, even for respondents who agree with this statement, is not severe enough to result in over-deterrence. Figure 10 shows this line of reasoning.

[138] In addition to the Mann-Whitney U test based on the independent survey variable "Are there any limitations of financial supervisory liability that you know of" (Table 10), I have carried out two Kruskal-Wallis tests to control for national variation and variation based on liability regime. The first Kruskal-Wallis test was based on the independent survey variable "In which county are you located" (control for national variation). This test showed no statistically significant differences between the different countries. Next, using earlier research (Dijkstra, 2012), I categorized each financial supervisory authority into one of the following liability regimes: "no-fault", "negligence", "gross-negligence" or "immunity". Based on this classification, I carried out a Kruskal-Wallis test which also showed no statically significant differences. Both tests confirm the overall outcome of this study.

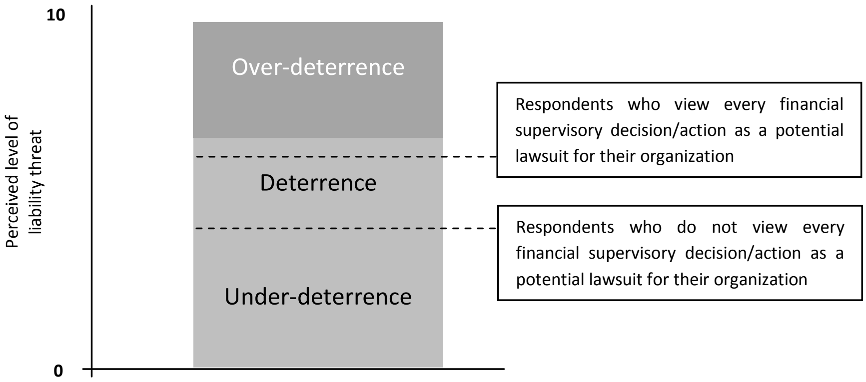


**Figure 10: Impact of the level of liability threat.**

The liability threat that financial supervisors face is dependent on the liability threats their organizations face. Table 20 presents the outcome of three questions related to liability that could give an indication of the actual liability threat financial supervisory authorities face.

**Table 20: Financial supervisory liability in the last 5 years.**

| | N | % of total | N (authorities)* | % of total |
|---|---|---|---|---|
| Has your organization been held liable in the past 5 years? | | | | |
| Yes | 36 | 34% | 26 | 60% |
| No | 47 | 45% | 15 | 35% |
| I do not know | 22 | 21% | 2 | 5% |
| How often has your organization been held liable in the past 5 years? | | | | |
| < 5 times | 15 | 42% | 12 | 46% |
| 5 – 15 times | 7 | 19% | 7 | 27% |
| > 15 times | 4 | 11% | 4 | 15% |
| I do not know | 10 | 28% | 3 | 12% |
| How often has a court established liability and sentenced your organization to payout compensation for damages in the last 5 years? | | | | |
| Never | 18 | 50% | 15 | 56% |
| < 5 times | 8 | 22% | 6 | 22% |
| > 5 times | 1 | 3% | 1 | 4% |
| I do not know | 9 | 25% | 5 | 19% |

More than half of the financial supervisory authorities have been held liable in the past five years. However, examining the liability frequency, it becomes clear that approximately 46% of these authorities have been held liable fewer than five times during this period, while only 15% have been held liable more than 15 times. Table 20 also shows that most financial supervisory authorities who have been sued have never been found liable by a court. It seems that financial supervisory authorities face a relatively low level of liability threat.[139] This threat is probably being mitigated even more as it concerns institutional liability and not personal liability. To impact the behaviour of individual financial supervisors, the threat of institutional liability needs to be transferred to the individual supervisors in an efficient way. In practice, this might be difficult to achieve, and consequently, it mitigates the impact of liability on the behaviour, or at least the perceptions, of individual financial supervisors.[140] The

[139] Based on table 12, it is not likely that the 'floodgates' argument, often used by opponents of applying normal liability rules, and, that is frequently connected to the idea of defensive conduct, holds ground.

[140] It should be noted that the threat of institutional liability could, to a certain extent, be transferred to employees through its negative impact on reputation. This reputation damage could impact the career opportunities of financial supervisors. Furthermore, some financial authorities can, in theory, initiate recourse actions against individual

idea that the actual liability threat faced by financial supervisors is relatively low is also confirmed by the data presented in Table 21.

**Table 21: Mann-Whitney U test on the impact of liability.**

| | N | *U* | *Z* | *p-value* |
|---|---|---|---|---|
| (2) Financial supervisory liability cases have changed our internal policies regarding the way we perform our supervisory tasks. | 105 | 848 | -2.76 | 0.006* |
| (2a) The changed internal policies improve the effectiveness of our financial supervision. | 72[1] | 609 | -0.19 | 0.850 |
| (2b) The purpose of the changed internal policies is to mitigate the risk of future lawsuits. | 72[1] | 461 | -2.00 | 0.045* |
| (3) The existing threat of supervisory liability results in fewer supervisory activities than desired. | 105 | 1197 | -0.32 | 0.748 |
| (4) Every supervisory decision has to be checked with our legal department (internal or external) before being announced or published. | 105 | 1008 | -1.66 | 0.097 |
| (4a) The involvement of our legal department increases the quality of our financial supervision. | 63[2] | 439 | -0.58 | 0.560 |
| (4b) The involvement of our legal department prevents us from reacting fast when that is required. | 63[2] | 421 | -0.80 | 0.422 |
| (5) The existing liability regime has a positive impact on the quality of financial supervision. | 105 | 1221 | -0.16 | 0.871 |
| (6) The existing liability threat results in more careful supervisory decisions. | 105 | 991 | -1.85 | 0.065 |
| (7) I do not see any concrete impact of a threat of supervisory liability on the supervisory activities of my organization. | 105 | 982 | -1.85 | 0.064 |
| (8) Our organization would be more effective without the threat of liability. | 105 | 1036 | -1.51 | 0.132 |

* Statistically significant $p < 0.05$
[1] Number of respondents who answered "neutral," "agree," or "strongly agree" on statement (1)
[2] Number of respondents who answered "agree" or "strongly agree" on statement (4)

Table 21 reports the outcome of a Mann-Whitney U test based on the independent variable: "Has your organization been held liable in the past five years?" For this survey, the answers "No" and "I do not know" have been combined, as neither of these groups are aware of any liability cases against their organizations. Only two statements have statistically significant differences, namely, statements (2) and (2b).[141] First, respondents whose organizations have been held liable (Md = 4, N = 36) are more convinced that liability cases have changed their internal policies than

supervisors in case they have been found liable by courts. This could provide individual supervisors incentives for taking adequate care.

[141] An explanation of these differences can also be based on behavioural insights, especially the availability heuristic. People tend to think that risks are more serious, when an incident is readily called to mind or 'available' (Sunstein, 2000).

respondents whose organizations have not been held liable (Md = 3, N = 69). Secondly, respondents whose organizations have been held liable (Md = 4, N =29) are more convinced that the changed internal policies serve to mitigate the risk of future lawsuits compared to those whose organizations have not been held liable (Md = 3, N = 43). These differences are not surprising and do not change the overall neutral or positive view on the impact of financial supervisory liability.

The outcome of this test demonstrates that actual liability claims do not result in a negative view on the impact on behaviour. This can probably be explained by the fact that the risk of supervisory liability is in general a low probability event.

### *6.6 Conclusion*

The concept of defensive conduct is one of the main arguments for countries to limit the liability of their financial supervisory authorities to cases of gross negligence or bad faith. The actual deterrent effect of financial supervisory liability is, however, debated, and there exists no empirical research to support this effect. This work fills a gap in that it is the first empirical study of the impact of financial supervisory liability.

Interestingly, the outcome of the survey showed that most of the respondents classify the impact of financial supervisory liability as neutral or positive. At most, the evidence from the survey implies, therefore, an arguably modest degree of deterrence. The relatively neutral or positive attitude suggests further that financial supervisors do not see financial supervisory liability as a burden in executing effective financial supervision. As the survey found no significant differences between respondents who perceive the liability of their organization as limited and those who do not, it also indicates that limiting financial supervisory liability does not have an impact on the behaviour, or at least on the perceptions of the impact of financial supervisory liability, of financial supervisors. Therefore, the study calls into question the widely accepted argument of defensive conduct as a reason for limiting the liability of financial supervisory authorities.

A possible explanation for this outcome could be that financial supervisory authorities, independent of the liability regime in which they operate, face a relative small liability threat. This line of reasoning seems to be confirmed by the relatively low level of liability cases against financial supervisory authorities during the last five years. This threat is probably being mitigated even more for individual financial supervisors, as it concerns institutional liability and not personal liability. To affect the behaviour of individual financial supervisors, the threat of institutional liability needs to be transferred to the individual supervisors in an efficient way. In practice, this might be difficult to achieve, and consequently it is likely to mitigate the impact of liability on financial supervisors. The fact that the survey did not reveal any important differences in perceptions between respondents whose organizations actually have been held liable and those whose organizations have not been held liable also seems to confirm this.

This research may represent an important first step in understanding the impact of financial supervisory liability. More targeted research, for instance through the use of case studies, could enrich the results of the current survey and delve further into the impact of financial supervisory liability on financial supervisors.

# 7 Conclusion

## *7.1 Introduction*

Since the financial crisis of 2008, the topic of financial supervisory liability has been frequently discussed. At the centre of this discussion is the question of whether or not third party liability of financial supervisory authorities should be limited. Politicians, legislators and legal scholars use various arguments against or in favour of limited financial supervisory liability. This study revolves around three arguments that often play a major role in the discussion of whether or not to limit third-party financial supervisory liability.

Two of these arguments are in favour of limited financial supervisory liability. First, when limiting the liability of their financial supervisory authorities, politicians and legislators frequently refer to the limited liability regimes of other countries. Second, it has been suggested that normal liability rules (e.g. negligence) would result in defensive conduct and hence inhibit the effective operations of financial supervisory authorities. Limiting financial supervisory liability would prevent this from happening. To the contrary, the third argument supports the application of normal liability rules.[142] In this view, the threat of being held liable would give financial supervisory authorities an incentive to perform their assigned tasks with adequate care.

Despite the major role these arguments play in the larger conversation about supervisory liability, it is important to consider the evidence, or lack thereof, that often underpins them. A closer examination reveals five specific gaps in our knowledge about financial supervisory liability. This could, at least to some extent, explain why the three arguments are valued differently. As a result of these different valuations, politicians, legislators and legal scholars will prefer a certain financial supervisory liability regime to another.

This work aims to examine whether the three arguments actually hold true. To this end, new data has been collected in five studies. This work then contributes to a better understanding of financial supervisory liability and provides further guidance on the debate. In this final chapter, I will outline the main findings of each previous chapter (Section 7.2) and demonstrate how they influence the central question of this study (Section 7.3). The chapter ends with Section 7.4, which sets forth some final thoughts concerning the answer of whether or not financial supervisory liability should be limited.

[142] The term "normal liability rules" refers to liability rules that are formally not limited (in most cases simple negligence).

*7.2 Findings*

### 7.2.1 Gap 1: Financial supervisory liability regimes in the EU

The first gap relates to our knowledge about financial supervisory liability regimes in other countries. We have seen that politicians, legislators and legal scholars often refer to limited financial supervisory regimes in other countries when arguing for a limitation of the liability of their own financial supervisory authorities. This is not surprising given the fact that, from a European perspective, financial supervisory liability is becoming increasingly important (Athanassiou, 2011). Existing comparative research focuses only on a limited number of EU member states (Andenas & Fairgrieve, 2000; Tison, 2005; Van Dam 2006a, De Kezel et al, 2009). Chapter 2 builds upon this earlier work by collecting data on third party financial supervisory liability regimes in all EU member states.

Chapter 2 shows that an increasing number of member states formally limit the liability of their financial supervisory authorities by using specific provisions in legislation. In recent years, Belgium (2002), Italy (2005), Austria (2008), and the Netherlands (2012) have limited the liability of their financial supervisory authorities. A closer look reveals that these limitations often take the form of a standard of gross negligence and/or bad faith; the use of complete immunities is scarce. Only two financial supervisory authorities, the German Financial Supervisory Authority 'Bafin' and the Austrian Financial Markets Authority 'Finanzmarktaufsicht', are completely immune to third party liability claims. Despite the fact that an increasing number of member states have formally limited the liability of their financial supervisory authorities, there is still a substantial number of member states who apply a rule of no-fault or (simple) negligence. There is therefore no common approach to financial supervisory liability in the EU.

It is only when we take into account weighting factors to express the relative importance of a member state in the EU (e.g. GDP or population size) that limited third party liability prevails over non-limited third party liability (no-fault, negligence). Thus, from a 'weighted perspective' there exists a European practice of limited financial supervisory liability. A closer examination of this weighted practice reveals that gross negligence is the most frequently used standard for formally limiting financial supervisory liability.

Readers should be aware that the research in Chapter 2 focuses mainly on the standard for liability as stated in the legislation of a member state. However, the standard of liability is merely one of the requirements for holding financial supervisory authorities liable. Other requirements are the existence of damage and a causal relationship between damage and the behaviour of the tortfeasor. The interpretation of the behavioural standard and these other requirements will often differ among member states because of their various historical and cultural backgrounds. This can result in liability more or less often. Despite this limitation, Chapter 2 still provides an important overview of financial supervisory liability regimes as stated in the legislation of European member states. This chapter can therefore be considered a starting point for future, more in depth, comparative research.

### 7.2.2 Gap 2: Theoretical knowledge about the deterrent impact of financial supervisory liability

The second gap relates to our knowledge about the deterrent impact of financial supervisory liability. Politicians, legislators and legal scholars often state simply that financial supervisory liability results in defensive conduct or prevents negligent conduct from occurring. In doing so, they refer to general and widely-used insights from law and economics theory on the deterrent impact of tort law. Unfortunately, these general insights do not take the specific context in which financial supervisory authorities operate into account. Therefore, Chapter 3 addresses this context by identifying a number of important characteristics that are likely to influence the deterrent impact of financial supervisory liability.

The first characteristic is the applicable standard of care. Normal liability rules refer in most cases to a standard of 'reasonable care'. We have seen that this is, in practice, a relatively vague and uncertain standard. What does this uncertainty mean for the deterrent impact of financial supervisory liability[143]? Uncertainty changes the deterrent impact of liability by creating two opposing effects. The first is an incentive to over-comply as a result of over-deterrence, while the second is an incentive to under-comply as uncertainty creates a probability that the injurer will not be held liable. Which effect will prevail? In order to provide financial supervisory authorities with the correct incentives to prevent losses, damages should be based on the social losses caused by the financial supervisory authorities. If damages are in excess of social loss, over-deterrence is more likely because there is an additional pay-off of decreasing the probability of being held liable. This line of reasoning assumes that the damage consists of pure economic loss (namely the monetary losses for depositors), which does not have to correspond with the total social loss as this accounts for third party earnings (transfer of wealth). On the other hand, if damages are lower than the social loss, under-deterrence will likely be the result since the financial supervisory authority is not responsible for the total costs of his behaviour. This may be the case when a financial institution's bankruptcy results in an overall lack of faith in the financial markets, subsequently causing a financial crisis.

[143] If the standard of care is precise, over-compensation (compensation amount is higher than social costs) will not lead to over-deterrence as the potential injurer knows ex ante which level of care is necessary to avoid liability.

In theory, the problem of over-deterrence can be solved by negligence rules, which restrict compensation to cases of obvious negligence or wilful behaviour. Compared to simple negligence, a standard of gross negligence can be considered more precise. Although it is not always clear what is meant by reasonable financial supervision, it is easier to determine whether certain behaviour is grossly negligent. The change from a negligence regime to a gross negligence regime is thus likely to limit the occurrence of over-deterrence. On the other hand, when social costs exceed the pure economic loss of third parties, financial supervisory authorities will, independent of a standard of negligence or gross negligence, face under-deterrence since they will not face the full financial consequences of their negligent behaviour.

Chapter 3 also demonstrates that, in order to work properly, the threat of being held liable must be severe enough to give financial supervisory authorities sufficient incentives to behave carefully. The main threat of liability arises from the damage compensation an authority must pay if found (grossly) negligent. From this perspective, the existence of a deposit guarantee system plays an important role. Third party financial supervisory liability will often follow the bankruptcy of a financial institution. In this situation, tort law is not the only mechanism that can provide compensation. In the event of a financial institution's bankruptcy, the deposit guarantee system ensures an amount of € 100,000 in compensation for depositors. As a result, the majority of the depositors will be fully compensated and thus have no incentive to hold the financial supervisory authority liable. The existence of a deposit guarantee system thus greatly mitigates the incentive-generating capacity of tort law, ultimately resulting in under-deterrence.

The existence of a deposit guarantee system is not the only factor that impacts the amount of compensation a financial supervisory must pay if found (grossly) negligent. The situation here in the Netherlands illustrates this perspective well. The Netherlands has safeguard clauses in place between the Dutch financial supervisory authorities and the Ministry of Finance. These safeguard clauses limit a financial supervisory authority's financial risk to a certain percentage of its budget. The remainder of the damage is then compensated by the Dutch state. In addition to safeguard clauses, Dutch financial supervisory authorities can also partially insure their liability risk. Both mechanisms ensure that Dutch financial supervisory authorities do not face the full consequences of their grossly negligent behaviour, thus mitigating the deterrent impact of financial supervisory liability even further. [144]

[144] If the insured financial supervisory authority no longer has to bear the full cost of its behaviour it often may lead to more risky behaviour. In order to avoid this change in behaviour, insurance companies attempt to set their premiums in such a way that the insured party still has an incentive to take adequate care. But in order to give financial supervisory authorities incentives to behave carefully, it is necessary that the insurance company is able to observe the level of care taken by financial supervisory authorities. Depending on how adequate the insurance company is capable of doing this, financial supervisory authorities will face more or less effective incentives (Cooter & Ulen, 2008).

When taking into account the specific context in which (Dutch) financial supervisory authorities operate, Chapter 3 makes clear that financial supervisory liability is most likely to result in under-deterrence. It therefore questions the defensive conduct argument and challenges the idea that financial supervisory liability is able to optimally prevent negligent conduct.

### 7.2.3 Gap 3: Alternative instruments for achieving deterrence

Theoretically, financial supervisory liability is not the only instrument that can provide incentives for financial supervisory authorities to behave carefully. If other accountability arrangements are able to provide effective incentives, the deterrent impact of financial supervisory liability becomes less important. The third identified gap therefore relates to the incentive-generating capacity of other accountability arrangements in comparison with financial supervisory liability, addressed in Chapter 4.

In addition to financial supervisory liability this chapter identifies four consequences of being held accountable. Firstly, financial supervisory failure can result in the suspension or dismissal of a member of the authority's management. Secondly, the Minister of Finance has the power to decide whether he will perform one or more aspects of the supervisor's function or have another supervisor perform them. Thirdly, Parliament has the right to execute surveys about the role of the financial supervisory authority in a particular case. Finally, the fourth consequence that may arise from being held accountable is damage to reputations, which can relate either to the financial supervisory authority itself or to its individual employees.

Chapter 4 makes clear that, despite the fact that most of these consequences may have a negative financial impact (directly or indirectly by means of reputation damage) on the private wealth of a financial supervisor or on the budget of the supervisory authority, the likelihood that these consequences will occur in practice can be considered low (with an exception for reputation damage). It is therefore unlikely that these alternative accountability arrangements provide the financial supervisory authorities with sufficient incentives to perform their supervisory tasks with adequate care.

### 7.2.4 Gap 4: The influence of compensation mechanisms on incentives for welfare-improving behaviour

Financial supervisory liability is not the only mechanism people can rely on to receive compensation for losses in the event of the bankruptcy of a financial institution. As we have already seen in Chapter 3, victims of bankrupted financial institutions will often receive compensation from a deposit guarantee system. But they can also attempt to secure compensation by submitting a claim to the liquidator of the financial institution. To what extent do these alternative compensation mechanisms influence the incentives of various stakeholders such as depositors, financial institutions, and financial supervisory authorities? And to what extent does a deposit guarantee system impact the incentive-generating capacity of financial supervisory liability? These questions are considered the fourth gap in our knowledge about financial supervisory liability and are addressed in Chapter 5.

Chapter 5 illustrates that the compensation system in the Netherlands will not prevent the failure of a financial institution by providing sufficient incentives for all stakeholders. Furthermore, the existence of a deposit guarantee system has a negative impact on the incentives arising from financial supervisory liability. This is due to the fact that persons who have received full compensation from the deposit guarantee system are not likely to hold the financial supervisory authority liable.

In order to improve the current compensation system with regard to incentives, the chapter suggests reducing the coverage level, introducing co-insurance, and changing the finance (funding) structure of the deposit guarantee fund. The chapter indicates that, looking only at the incentives of tort law, the best solution would be to lower the current coverage level of the deposit guarantee system, which would improve the incentives of all parties involved. For instance, it would increase the likelihood that financial supervisory authorities are held liable by third parties, thereby improving the deterrent impact of financial supervisory liability. However, it is not possible to lower the coverage level under current European legislation, and additionally it may be undesirable from other perspectives such as optimal compensation. With respect to the other suggestions, it is important to note that, as of 1 July 2015, the funding of the Dutch deposit guarantee system will be based on ex ante risk-based premiums, which is likely to improve incentives for financial institutions.[145]

Chapter 5 also discusses the possibility of abandoning the use of tort law. In practice, due to the existence of the deposit guarantee system, tort law has no major role in compensating victims of bankrupted financial institutions. From this compensation perspective, there are no strong arguments supporting the use of tort law. Our analysis suggests that abandoning tort law would likely give depositors, who have deposits in excess of the coverage provided by the deposit guarantee system, more incentives to carefully select their financial institution. However, since this specific group of depositors is relatively small, the impact would be minor.

On the other hand, abandoning the use of tort law would negatively affect the incentives of financial supervisory authorities. This negative effect is limited due to the fact that the existence of a rather generous deposit guarantee system already results in

[145] See Dutch Ministry of Finance, FM / 2012 478 M.

a smaller likelihood that financial supervisory authorities will be held liable. Because tort law fulfils functions with regard not only to compensation and prevention but also to the perception of justice in society, it is unclear whether abandoning the use of tort law entirely will be a socially acceptable solution.

### 7.2.5 Gap 5: Empirical research on the impact of financial supervisory liability

Ultimately, the question of the impact of financial supervisory liability on the behaviour of financial supervisory authorities is an empirical one. Surprisingly, little empirical evidence has been put forth on the behavioural impact of financial supervisory liability to date.[146] Chapter 6 aims to address this gap by presenting the outcome of a European survey on the impact of financial supervisory liability.

By surveying more than 500 senior financial supervisors across 27 EU member states, this chapter shows that the majority of respondents classify the impact of financial supervisory liability as either neutral or positive. The findings from the survey therefore imply a modest degree of deterrence. Furthermore, the relatively neutral or positive attitude suggests that financial supervisors do not consider financial supervisory liability a burden in executing effective financial supervision. The survey found no significant differences between those respondents who perceive the liability of their organization as limited and those who do not. This suggests that limiting financial supervisory liability does not affect perceptions of the impact of financial supervisory liability or possibly even the behaviour of financial supervisors. The chapter thus calls into question the relevance of defensive conduct as an argument for limiting the liability of financial supervisory authorities.

A possible explanation for this outcome may be that financial supervisory authorities, independent of the liability regime in which they operate, face a relatively small threat of actually being found liable. This line of reasoning seems to be confirmed by the low number of liability cases against financial supervisory authorities over the last five years. As this threat is about institutional liability and not personal liability, it is likely being further mitigated for individual financial supervisors. To impact the behaviour of individual financial supervisors, the threat of institutional liability must be transferred to the individual supervisors. In practice, this may be difficult to achieve and consequently it is likely to mitigate the impact of liability on financial supervisors. This seems to be confirmed by the fact that the survey did not reveal any important differences in perceptions between respondents whose organizations have actually been held liable and those whose organizations have not.

[146] Se Section 1.3 of this study for a brief overview of empirical research related to the behavioural impact of financial supervisory liability.

Chapter 6 both complements and challenges the existing (theoretical) notions about the deterrent impact of financial supervisory liability by providing empirical data. However, readers should be aware of the limitations of this empirical research. While the survey responses reflect the observations and perceptions of the financial supervisors, perceptions may differ from actual behaviour. Additionally, responses may be biased if respondents were inclined to offer a socially desirable response or to achieve political goals.

Notwithstanding its complexity, empirical research is important because it is the only type of research that can reveal how and to what extent (limited) financial supervisory liability actually impacts financial supervision. This emphasises the need for future empirical research on the impact of financial supervisory liability. Empirical research in various ways (e.g. online surveys, interviews, case studies) and by different scholars is likely to ultimately provide a more accurate picture of the impact of financial supervisory liability.

## *7.3 Conclusion: to what extent do the three arguments hold true?*

### 7.3.1 Referring to limited financial supervisory liability regimes

Referring to limited financial supervisory liability regimes in other countries is a popular practice amongst politicians, legislators and legal scholars. Belgian legislators, for instance, referred to Germany when they limited the liability of their financial supervisory authorities in 2002 to cases of gross negligence and/or bad faith (De Kezel et al., 2009). Similarly, Ireland's introduction of a standard of bad faith for the supervisory authorities was inspired by the situation in the United Kingdom (Doherty & Lenihan, 2005). In addition, Dutch politicians explicitly referred to the limited liability regimes of neighbouring countries (Belgium, Germany, and the United Kingdom) in 2012 when they introduced a standard of gross negligence and/or bad faith.[147] But to what extent does this argument actually hold true?

Earlier comparative research – as well as the findings of chapter 2 – confirms that the countries mentioned above have formally limited the third party liability of their financial supervisory authorities. Referring to the limited liability regimes of these countries thus seems a valid argument. But is it convincing? Chapter 2 shows that there are still a number of member states that apply a rule of no-fault or (simple) negligence. This could imply that referring to limited financial supervisory liability regimes is conveniently selective. Depending on one's preference for a specific financial supervisory liability regime, one refers to countries that either have a limited liability regime or apply normal liability rules. From this perspective, referring to

[147] See fn. 3.

limited financial supervisory liability regimes does not seem to be a very objective or convincing argument.

However, this view changes when we take into account weighting factors (GDP or population size) to express the relative importance of a member state in the EU. If we use weighting factors, it becomes clear that limited third party liability (gross negligence, bad faith, immunity) is dominant over non-limited third party liability (no-fault, negligence). This suggests that referring to countries that have limited the liability of their financial supervisory authorities is a stronger argument than referring to countries that have applied normal liability rules.

Despite its attractiveness, politicians, legislators and legal scholars should be cautious about using the legal situations of other countries as a decisive argument for limiting the liability of their own financial supervisory authorities. The fact that other countries have limited the liability of their financial supervisory authorities may reflect a kind of collective wisdom, but it may also relate to herd behaviour or a specific political reaction such as to the events following a particular financial institution's bankruptcy. It does not provide us with a fundamental justification for limiting financial supervisory liability. The question of why these countries have limited their financial supervisory authorities' liability remains unanswered. Unless this can be answered, referring to limited financial supervisory liability regimes should merely be seen as a supportive argument in the debate rather than a decisive one.

### 7.3.2 Is fear for defensive conduct justified?

The behavioural impact of financial supervisory liability is perhaps the most intriguing topic in the discussion about financial supervisory liability. Why? It is being used as an argument both in favour of, as well as against financial supervisory liability. In regards to the latter view, there are concerns that financial supervisory liability will lead to over-deterrence and thus defensive conduct. In other words, the threat of financial supervisory liability will inhibit financial supervisory authorities' effective financial supervision. In order to prevent this from happening, limiting financial supervisory liability to cases of gross negligence and/or bad faith is recommended. The contrary assertion is that financial supervisory liability improves financial supervision by deterring the careless execution of financial supervisory tasks. This view then promotes the application of normal liability rules (e.g. negligence).

The theoretical and empirical findings of this study suggest that normal liability rules are not likely to result in over-deterrence. The main reason can be found in the specific context in which financial supervisory authorities operate. Third party financial supervisory liability is, in most cases, triggered by the bankruptcy of a financial institution. As such bankruptcies do not happen frequently, financial supervisory authorities generally face a relatively minor liability threat. And, when a financial institution does goes bankrupt, the existence of a deposit guarantee system at least partially shields financial supervisory authorities from third party liability, as most victims will be compensated in full by this system.

The deposit guarantee system is, however, not the only mechanism able to mitigate the liability threat. In the Netherlands, for instance, there are safeguard clauses between the financial supervisory authorities and the Ministry of Finance that effectively transfer a large portion of the financial risk from the supervisory authorities to the Dutch state. In addition to safeguard clauses, Dutch financial supervisory authorities can also insure their liability risk, thereby reducing the financial risk of being held liable. Both arrangements limit the amount of compensation that financial supervisory authorities need to pay if found (grossly) negligent. This is likely to reduce the liability threat they face, which is probably mitigated even further as it concerns institutional liability and not personal liability. To affect the behaviour of individual financial supervisors, the threat of institutional liability needs to be transferred to the individual supervisors, however this may be difficult to achieve in practice.

Taking all of these factors into account, it is difficult to believe that financial supervisory authorities will actually engage in defensive conduct. Both the empirical and theoretical findings of this study therefore suggest that the argument of defensive conduct has less value than was assumed by some authors prior to the execution of these studies.

### 7.3.3 Does financial supervisory liability result in careful supervision?

Although normal liability rules are not likely to result in defensive conduct, the question remains whether these are capable of efficiently deterring the careless execution of financial supervision, and thus promoting effective financial supervision. In this perspective, it is helpful to separate two distinct forms of the deterrence argument (Schwartz, 1994). In its strong form, the argument insists that tort law does indeed deter in the comprehensive systematic way that economic models suggest. The argument's more moderate form concedes that tort law does not deter comprehensively, yet still claims that tort practices provide some meaningful amount of deterrence.

This study casts genuine doubt on the strong version of the deterrence argument. Chapter 3 shows that financial supervisory liability is most likely to result in under-deterrence, while the empirical findings of Chapter 6 indicate only a modest degree of deterrence. It therefore seems that financial supervisory liability is incapable of achieving optimal deterrence, suggesting that the strong version of the deterrence argument should be rejected. However, the findings of this study are not inconsistent with the deterrence argument in its moderate form. Financial supervisory liability, while not as effective as economic models suggests, may still contribute to achieving the stated deterrence goals. The threat of financial supervisory liability is therefore likely to exert a certain amount of pressure on financial supervisory authorities to alter their behaviour in a more socially desirable way.

Is financial supervisory liability a requisite element for achieving (suboptimal) deterrence? There are a number of alternative (internal and external) mechanisms available to regulate the activities of financial supervisory authorities independently of tort law (Sugarman, 1985). The most important external alternative mechanisms are: the possibility of dismissing members of the financial supervisory authority's management, the right of parliament to perform inquiries regarding the authority's role in a particular case, and the fear of reputation damage as a result of negative publicity. If these alternative mechanisms provide financial supervisory authorities with sufficient incentives to perform their supervisory tasks with adequate care, financial supervisory liability may be dispensable.

The findings of this study suggest that a number of important external alternative mechanisms are unlikely to provide financial supervisory authorities with sufficient incentives (Chapter 4). Thus, while there is scope for conflict and competition between the various mechanisms, viewing them as potentially complementary can be valuable (Adler, 2003). Moreover, it may be the case that financial supervisory liability has the capability to interact with other incentives in a beneficial way. Tort actions can, for instance, generate publicity (in some cases resulting in reputation damage) or uncover information in a way that can set policy changes in motion. Although generating information can be economically valuable, solely using the tort litigation system to generate this information may be very costly, especially when it is not clear whether it is the event itself or the tort suit that generates information (De Mot & Faure, 2012; Dari-Mattiacci et al, 2010).

In summary, despite the fact that financial supervisory liability does not deter comprehensively, it tends to play a valuable role – in conjunction with other mechanisms – in providing financial supervisory authorities with incentives to behave carefully. However, in order to better understand the interaction between the various incentive generating mechanisms, more empirical interdisciplinary research is needed.

## *7.4 Final thoughts*

Having read the last section, the reader may ask what the outcome of this study means for the question of whether or not to limit financial supervisory liability. Although this study did not validate and weigh all arguments against or in favour of financial supervisory liability, it may be worthwhile to share some thoughts on answering this question.

Under normal circumstances, one would expect that public authorities, and thus financial supervisory authorities, should be treated in the same way as other defendants (Dicey, 1915). The general elements of negligence normally provide sufficient flexibility to ensure that an appropriate balance is maintained between claimant and defendant (Bailey, 2006). Therefore, there needs to be a good reason for restricting financial supervisory liability.

While multiple arguments could explain the rationale for limited financial supervisory liability, the fear of defensive conduct can probably be considered the most important. As the findings of this study suggest that this argument has less value than commentators tend to assume, we should be skeptical about the desirability of limiting financial supervisory liability based on this argument. Would this then also mean that governments who have adopted a rule of gross negligence and/or bad faith should start thinking about reforming their financial supervisory liability regimes? The main issue here is the existence of depositor guarantee schemes. These schemes shield, to a certain extent, financial supervisory authorities from liability as compensated victims will not have many incentives to sue them. As long as depositor guarantee schemes exist, the deterrent impact of third party financial supervisory liability is likely to remain weak regardless of the choice between rules of negligence, gross negligence and/or bad faith.

One could thus seriously doubt whether there is a noticeable difference in deterrence between the rules of negligence, gross negligence and/or bad faith. The empirical findings of this study seem to confirm this, as there were no significant differences between financial supervisors who perceive their organization's liability as limited and those who do not. This would suggest that the choice of a rule of negligence, gross negligence and/or bad faith is, more or less, insignificant from a deterrence perspective.

The question of whether or not to limit financial supervisory liability should therefore be answered on different grounds than deterrence. The answer should probably be sought in terms of optimal compensation and cost efficiency. In this perspective, the use of tort law is being restricted in favour of an alternative, more cost-efficient, compensation mechanism such as a deposit guarantee system. This line of reasoning could thus partly justify limited financial supervisory liability. However, more research is needed before this can be fully asserted.

## Appendix 1: Overview of third party financial supervisory liability regimes in the EU

| Country | Financial Supervisory Authority | CATEGORY | | | | | |
|---|---|---|---|---|---|---|---|
| | | *No-fault* | *Negligence* | *Gross Negligence* | *Bad Faith* | *Immunity* | *Unknown* |
| Austria | FMA | | | | | X | |
| Belgium | NBB | | | X | | | |
| | FSMA | | | X | | | |
| Bulgaria | BNB | | | | X | | |
| | BFSC | X | | | | | |
| Cyprus | CBC | | | X | | | |
| | CySec | | | | | | X |
| | ICCS | | | | | | X |
| | CSSDA | | | | | | X |
| Czech Republic | CNB | X | | | | | |
| Denmark | DFSA | | X | | | | |
| Estonia | EFSA | | | | X | | |
| Finland | FIN-FSA | | X | | | | |
| France | AMF | | | X | | | |
| | ACP | | | X | | | |
| Germany | BaFin | | | | | X | |
| Greece | BoG | X | | | | | |
| | HCMC | X | | | | | |
| Hungary | HFSA | | X | | | | |
| Ireland | CBI | | | | X | | |
| Italy | ISVAP | | | X | | | |
| | COVIP | | | X | | | |
| | CONSOB | | | X | | | |
| | BoI | | | X | | | |
| Latvia | FKTK | | | X | | | |
| Lithuania | BoL | X | | | | | |
| Luxembourg | CSSF | | | X | | | |
| | CAA | | | X | | | |
| Malta | MFSA | | | | X | | |
| Netherlands | DNB | | X | | | | |
| | AFM | | X | | | | |
| Poland | NBP | X | | | | | |
| | PFSA | X | | | | | |
| Portugal | BdP | | X | | | | |
| | CMVM | | X | | | | |
| | ISP | | X | | | | |
| Romania | BNR | | | | | | X |
| | CNVM | | | | | | X |
| | CSA | | | | | | X |
| Slovakia | NBS | X | | | | | |
| Slovenia | BoS | | X | | | | |
| | SMA | | X | | | | |
| | ISA | | X | | | | |
| Spain | BdE | X | | | | | |
| | CNMV | X | | | | | |
| | DGSFP | X | | | | | |
| Sweden | SFSA | | X | | | | |
| United Kingdom | FSA | | | | X | | |
| **Total** | **48** | **11** | **12** | **12** | **5** | **2** | **6** |

## Appendix 2: Third party financial supervisory liability regimes in the EU (one member state, one vote)

| Country | Number of votes | Financial Supervisory Authority | CATEGORY | | | | | |
|---|---|---|---|---|---|---|---|---|
| | | | *No-fault* | *Negligence* | *Gross Negligence* | *Bad Faith* | *Immunity* | *Unknown* |
| Austria | 1 | FMA | | | | | 3.7% | |
| Belgium | 1 | NBB | | | 1.9% | | | |
| | | CBFA | | | 1.9% | | | |
| Bulgaria | 1 | BNB | | | | 1.9% | | |
| | | BFSC | 1.9% | | | | | |
| Cyprus | 1 | CBC | | | 0.9% | | | |
| | | CySec | | | | | | 0.9% |
| | | ICCS | | | | | | 0.9% |
| | | CSSDA | | | | | | 0.9% |
| Czech Republic | 1 | CNB | 3.7% | | | | | |
| Denmark | 1 | DFSA | | 3.7% | | | | |
| Estonia | 1 | EFSA | | | | 3.7% | | |
| Finland | 1 | FIN-FSA | | 3.7% | | | | |
| France | 1 | AMF | | | 1.9% | | | |
| | | ACP | | | 1.9% | | | |
| Germany | 1 | BaFin | | | | | 3.7% | |
| Greece | 1 | BoG | 1.9% | | | | | |
| | | HCMC | 1.9% | | | | | |
| Hungary | 1 | HFSA | | 3.7% | | | | |
| Ireland | 1 | CBI | | | | 3.7% | | |
| Italy | 1 | ISVAP | | | 0.9% | | | |
| | | COVIP | | | 0.9% | | | |
| | | CONSOB | | | 0.9% | | | |
| | | BoI | | | 0.9% | | | |
| Latvia | 1 | FKTK | | | 3.7% | | | |
| Lithuania | 1 | BoL | 3.7% | | | | | |
| Luxembourg | 1 | CSSF | | | 1.9% | | | |
| | | CAA | | | 1.9% | | | |
| Malta | 1 | MFSA | | | | 3.7% | | |
| Netherlands | 1 | DNB | | 1.9% | | | | |
| | | AFM | | 1.9% | | | | |
| Poland | 1 | NBP | 1.9% | | | | | |
| | | PFSA | 1.9% | | | | | |
| Portugal | 1 | BdP | | 1.2% | | | | |
| | | CMVM | | 1.2% | | | | |
| | | ISP | | 1.2% | | | | |
| Romania | 1 | BNR | | | | | | 1.2% |
| | | CNVM | | | | | | 1.2% |
| | | CSA | | | | | | 1.2% |
| Slovakia | 1 | NBS | 3.7% | | | | | |
| Slovenia | 1 | BoS | | 1.2% | | | | |
| | | SMA | | 1.2% | | | | |
| | | ISA | | 1.2% | | | | |
| Spain | 1 | BdE | 1.2% | | | | | |
| | | CNMV | 1.2% | | | | | |
| | | DGSFP | 1.2% | | | | | |
| Sweden | 1 | SFSA | | 3.7% | | | | |
| United Kingdom | 1 | FSA | | | | 3.7% | | |
| **TOTAL** | **27** | **48** | **24.1%** | **25.9%** | **19.4%** | **16.7%** | **7.4%** | **6.5%** |

# Appendix 3: Third party financial supervisory liability regimes in the EU (population size)

| Country | # of inhabitants (* 1.000) | Financial Supervisory Authority | CATEGORY | | | | | |
|---|---|---|---|---|---|---|---|---|
| | | | *No-fault* | *Negligence* | *Gross Negligence* | *Bad Faith* | *Immunity* | *Unknown* |
| Austria | 8,404 | FMA | | | | | 1.7% | |
| Belgium | 10,918 | NBB | | | 1.1% | | | |
| | | FSMA | | | 1.1% | | | |
| Bulgaria | 7,504 | BNB | | | | 0.7% | | |
| | | BFSC | 0.7% | | | | | |
| Cyprus | 804 | CBC | | | 0.0% | | | |
| | | CySec | | | | | | 0.0% |
| | | ICCS | | | | | | 0.0% |
| | | CSSDA | | | | | | 0.0% |
| Czech Republic | 10,532 | CNB | 2.1% | | | | | |
| Denmark | 5,560 | DFSA | | 1.1% | | | | |
| Estonia | 1,340 | EFSA | | | | 0.3% | | |
| Finland | 5,375 | FIN-FSA | | 1.1% | | | | |
| France | 65,075 | AMF | | | 6.5% | | | |
| | | ACP | | | 6.5% | | | |
| Germany | 81,751 | BaFin | | | | | 16.3% | |
| Greece | 11,329 | BoG | 1.1% | | | | | |
| | | HCMC | 1.1% | | | | | |
| Hungary | 9,986 | HFSA | | 2.0% | | | | |
| Ireland | 4,480 | CBI | | | | 0.9% | | |
| Italy | 60,626 | ISVAP | | | 3.0% | | | |
| | | COVIP | | | 3.0% | | | |
| | | CONSOB | | | 3.0% | | | |
| | | BoI | | | 3.0% | | | |
| Latvia | 2,229 | FKTK | | | 0.4% | | | |
| Lithuania | 3,244 | BoL | 0.6% | | | | | |
| Luxembourg | 512 | CSSF | | | 0.1% | | | |
| | | CAA | | | 0.1% | | | |
| Malta | 418 | MFSA | | | | 0.1% | | |
| Netherlands | 16,655 | DNB | | 1.7% | | | | |
| | | AFM | | 1.7% | | | | |
| Poland | 38,200 | NBP | 3.8% | | | | | |
| | | PFSA | 3.8% | | | | | |
| Portugal | 10,637 | BdP | | 0.7% | | | | |
| | | CMVM | | 0.7% | | | | |
| | | ISP | | 0.7% | | | | |
| Romania | 21,413 | BNR | | | | | | 1.4% |
| | | CNVM | | | | | | 1.4% |
| | | CSA | | | | | | 1.4% |
| Slovakia | 5,435 | NBS | 1.1% | | | | | |
| Slovenia | 2,050 | BoS | | 0.1% | | | | |
| | | SMA | | 0.1% | | | | |
| | | ISA | | 0.1% | | | | |
| Spain | 46,152 | BdE | 3.1% | | | | | |
| | | CNMV | 3.1% | | | | | |
| | | DGSFP | 3.1% | | | | | |
| Sweden | 9,415 | SFSA | | 1.9% | | | | |
| United Kingdom | 62,435 | FSA | | | | 12.4% | | |
| **Total** | **502,479** | **48** | **23.6%** | **11.9%** | **27.8%** | **14.4%** | **17.9%** | **4.4%** |

## Appendix 4: Third party financial supervisory liability regimes in the EU (gross domestic product)

| Country | GDP (* € billion) | Financial Supervisory Authority | CATEGORY | | | | | |
|---|---|---|---|---|---|---|---|---|
| | | | *No-fault* | *Negligence* | *Gross Negligence* | *Bad Faith* | *Immunity* | *Unknown* |
| Austria | 284.4 | FMA | | | | | 2.3% | |
| Belgium | 352.9 | NBB | | | 1.4% | | | |
| | | FSMA | | | 1.4% | | | |
| Bulgaria | 36.0 | BNB | | | | 0.1% | | |
| | | BFSC | 0.1% | | | | | |
| Cyprus | 17.5 | CBC | | | 0.04% | | | |
| | | CySec | | | | | | 0.04% |
| | | ICCS | | | | | | 0.04% |
| | | CSSDA | | | | | | 0.04% |
| Czech Republic | 145.0 | CNB | 1.2% | | | | | |
| Denmark | 234.0 | DFSA | | 1.9% | | | | |
| Estonia | 14.5 | EFSA | | | | 0.1% | | |
| Finland | 180.3 | FIN-FSA | | 1.5% | | | | |
| France | 1,932.8 | AMF | | | 7.9% | | | |
| | | ACP | | | 7.9% | | | |
| Germany | 2,498.8 | BaFin | | | | | 20.4% | |
| Greece | 230.2 | BoG | 0.9% | | | | | |
| | | HCMC | 0.9% | | | | | |
| Hungary | 98.4 | HFSA | | 0.8% | | | | |
| Ireland | 153.9 | CBI | | | | 1.3% | | |
| Italy | 1,548.8 | ISVAP | | | 3.2% | | | |
| | | COVIP | | | 3.2% | | | |
| | | CONSOB | | | 3.2% | | | |
| | | BoI | | | 3.2% | | | |
| Latvia | 18.0 | FKTK | | | 0.1% | | | |
| Lithuania | 27.4 | BoL | 0.2% | | | | | |
| Luxembourg | 41.6 | CSSF | | | 0.2% | | | |
| | | CAA | | | 0.2% | | | |
| Malta | 6.2 | MFSA | | | | 0.1% | | |
| Netherlands | 591.5 | DNB | | 2.4% | | | | |
| | | AFM | | 2.4% | | | | |
| Poland | 354.3 | NBP | 1.4% | | | | | |
| | | PFSA | 1.4% | | | | | |
| Portugal | 172.7 | BdP | | 0.5% | | | | |
| | | CMVM | | 0.5% | | | | |
| | | ISP | | 0.5% | | | | |
| Romania | 121.9 | BNR | | | | | | 0.3% |
| | | CNVM | | | | | | 0.3% |
| | | CSA | | | | | | 0.3% |
| Slovakia | 65.9 | NBS | 0.5% | | | | | |
| Slovenia | 36.0 | BoS | | 0.1% | | | | |
| | | SMA | | 0.1% | | | | |
| | | ISA | | 0.1% | | | | |
| Spain | 1,062.6 | BdE | 2.9% | | | | | |
| | | CNMV | 2.9% | | | | | |
| | | DGSFP | 2.9% | | | | | |
| Sweden | 346.7 | SFSA | | 2.8% | | | | |
| United Kingdom | 1,696.6 | FSA | | | | 13.8% | | |
| **Total** | **12,268.9** | **48** | **15.5%** | **13.5%** | **31.8%** | **15.4%** | **22.7%** | **1.1%** |

## Appendix 5: European survey on financial supervisory liability

**Part I:**

| | |
|---|---|
| Question 1: | In which country are you located? |
| Question 2: | To which organization do you belong? |
| Question 3: | What is your role in the organization? |
| Question 4: | How long have you worked for this organization? |
| Question 5: | In what category of financial supervision are you active? |
| Question 6: | Is it possible to hold your organization liable based on shortcoming in performing financial supervision? |

**Part II:**

| | |
|---|---|
| Question 7: | Has your organization been held liable in the last 5 years? |
| Question 8: | How often has your organization been held liable in the last 5 years? |
| Question 9: | Who has held your organization liable? |
| Question 10: | How often has a court established liability and sentenced your organization to pay-out compensation for damages in the last five years? |
| Question 11: | Are there any limitations of financial supervisory liability regarding your organization, that you know off? |
| Question 11a: | Please describe what kind of limitations is (are) in place with a reference to specific legislation or case-law. |
| Statement 1: | I view every supervisory decision / action as a potential lawsuit for my organization. |

**Part III:**

| | |
|---|---|
| Statement 2: | Financial supervisory liability cases have changed our internal policies regarding the way we perform our supervisory tasks. |
| Statement 2a: | The changed internal policies improve the effectiveness of our financial supervision. |
| Statement 2b: | The purpose of the changed internal policies is to mitigate the risk of a future law suit. |
| Statement 3: | The existing threat of supervisory liability results in less supervisory activities than desired. |
| Statement 4: | Every supervisory decision has to be checked with our legal department (internal or external) before being announced or published. |
| Statement 4a: | The involvement of our legal department increases the quality of our financial supervision. |
| Statement 4b: | The involvement of our legal department prevents us from reacting fast when that is required. |
| Statement 5: | The existing liability regime has a positive impact on the quality of financial supervision. |
| Statement 6: | The existing liability threat results in more careful supervisory decisions. |
| Statement 7: | I don't see any concrete impact of a threat of financial supervisory liability on the supervisory activities of my organization. |
| Statement 8: | Our organization would be more effective without the threat of liability. |

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